



0000109732

Transcript Exhibit(s)

Docket #(s): RT-00000H-97-0137

T-00000D-06-0072

Exhibit #: See attached Exhibit List for the
Status of each Exhibit.

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To: Docket Control

Date: April 2, 2010

Re: AUSF Rules / Review
RT-00000H-97-0137, etc.
Volumes I through III, Concluded
March 16 through 18, 2010

STATUS OF ORIGINAL EXHIBITS

FILED WITH DOCKET CONTROL

Arizona Local Exchange Carriers Association (ALECA Exhibits)

1 through 3

Joint CLEC (JCLEC Exhibits)

1, 2, and 3

AT&T (AT&T Exhibits)

1, 3, 4, 6, 7, 9, 11 through 21

Sprint (Sprint Exhibits)

1, 2, 3, and 4

Residential Utility Consumer Office (RUCO Exhibits)

1 through 4

Cox (Cox Exhibits)

1 through 3

Verizon (VZ Exhibits)

2 through 4

Staff (S Exhibits)

1, 2, 4, 5, 6

Qwest (Q Exhibits)

1, 3, 5, 7, 8, 9

CONFIDENTIAL EXHIBITS
Given to ALJ Rodda

Joint CLEC (JCLEC Exhibits)

2A, 3A

AT&T (AT&T Exhibits)

2, 5, 8, 10

Sprint (Sprint Exhibits)

3A

Verizon (VZ Exhibits)

1

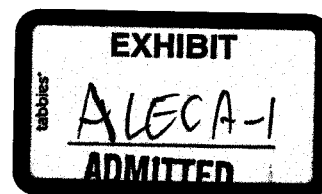
Staff (S Exhibits)

3

Qwest (Q Exhibits)

2, 4, 6

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BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS

KRISTIN K. MAYES, Chairman
GARY PIERCE
PAUL NEWMAN
SANDRA D. KENNEDY
BOB STUMP

IN THE MATTER OF THE REVIEW AND
POSSIBLE REVISION OF ARIZONA
UNIVERSAL SERVICE FUND RULES,
ARTICLE 12 OF THE ARIZONA
ADMINISTRATIVE CODE.

DOCKET NO. RT-00000H-97-0137

IN THE MATTER OF THE INVESTIGATION OF
THE COST OF TELECOMMUNICATIONS
ACCESS.

DOCKET NO. T-00000D-00-0672

**TESTIMONY OF
DOUGLAS DUNCAN MEREDITH
ON BEHALF OF
THE ARIZONA LOCAL EXCHANGE
CARRIERS ASSOCIATION**

1 I INTRODUCTION

2 Q: PLEASE STATE YOUR FULL NAME, PLACE OF EMPLOYMENT AND
3 POSITION.

4 A: My full name is Douglas Duncan Meredith. I am employed by John Staurulakis, Inc.
5 ("JSI") as Director – Economics and Policy. JSI is a telecommunications consulting firm
6 headquartered in Greenbelt, Maryland. My office is located at 547 Oakview Lane,
7 Bountiful, Utah 84010. JSI has provided telecommunications consulting services to rural
8 local exchange carriers since 1963.

9 Q: PLEASE DESCRIBE YOUR PROFESSIONAL EXPERIENCE AND
10 EDUCATIONAL BACKGROUND.

11 A: As the Director of Economics and Policy at JSI, I assist clients with the development of
12 policy pertaining to economics, pricing and regulatory affairs. I have been employed by

1 JSI since 1995. Prior to my work at JSI, I was an independent research economist in the
2 District of Columbia and a graduate student at the University of Maryland – College
3 Park.

4 In my employment at JSI, I have participated in numerous proceedings for rural and non-
5 rural telephone companies. These activities include, but are not limited to: the creation of
6 forward-looking economic cost studies; the development of policy related to the
7 application of federal safeguards for rural local exchange carriers; the determination of
8 Eligible Telecommunications Carriers pursuant to the Communications Act of 1934, as
9 amended ("Act"); and the sustainability and application of universal service policy for
10 telecommunications carriers.

11 In addition to assisting telecommunications carrier clients, I have served as the economic
12 advisor for the Telecommunications Regulatory Board of Puerto Rico since 1997. In this
13 capacity, I provide economic and policy advice to the Board Commissioners on all
14 telecommunications issues that have either a financial or economic impact. I have
15 participated in numerous Arbitration panels established by the Board to arbitrate
16 interconnection issues under Section 252(b) of the Telecommunications Act of 1996 (the
17 "Act").

18 I am participating or have participated in numerous national incumbent local exchange
19 carrier and telecommunications groups, including those headed by NTCA, OPASTCO,
20 USTA, and the Rural Policy Research Institute. My participation in these groups focuses
21 on the development of policy recommendations for advancing universal service and
22 telecommunications capabilities in rural communities and other policy matters.

23 I have testified or filed pre-filed regulatory testimony in various states including Indiana,
24 New Hampshire, Vermont, Maine, New York, Michigan, Wisconsin, North Dakota,

1 South Dakota, South Carolina, Texas, Kentucky, Utah, Florida, and Tennessee. I have
2 also participated in regulatory proceedings in many other states that did not require
3 formal testimony, including Florida, Washington, Louisiana, Mississippi, North Carolina,
4 Puerto Rico and Virginia. In addition to participation in state regulatory proceedings, I
5 have participated in federal regulatory proceedings through filing of formal comments in
6 various proceedings and submission of economic reports in an enforcement proceeding.

7 I have a Bachelor of Arts degree in economics from the University of Utah, and a
8 Masters degree in economics from the University of Maryland – College Park. While
9 attending the University of Maryland – College Park, I was also a Ph.D. candidate in
10 Economics. This means that I completed all coursework, comprehensive and field
11 examinations for a Doctorate of Economics without completing my dissertation.

12 **Q: ON WHOSE BEHALF ARE YOU TESTIFYING?**

13 **A:** I am testifying on behalf of the Arizona Local Exchange Carrier Association
14 (“ALECA”).

15 **Q: WHAT IS THE PURPOSE OF YOUR TESTIMONY?**

16 **A:** My purpose in providing this testimony to the Arizona Corporation Commission
17 (“Commission”) is to propose three revisions to the AUSF program. First, I explain
18 ALECA’s proposed revision to Arizona’s current intrastate switched access service
19 regime under which ALECA members provide service. Specifically, I review reform
20 efforts of interstate switched access in recent past and compare interstate reform with the
21 current intrastate switched access rate experience in Arizona. I explain the motivation for
22 ALECA’s position in this proceeding and outline a proposal for intrastate access reform
23 for ALECA’s members regulated by the Commission. Second, I introduce a proposed
24 rule that would establish a new mechanism that provides support for carrier’s high cost
25 loop in concert with the Federal High Cost Loop Support mechanism. Lastly, I also

1 provide a proposed rule related to the administration of lifeline and linkup that also would
2 be in the public interest.

3 **II FEDERAL INTERSTATE ACCESS REFORM**

4 **Q: WHY IS SWITCHED ACCESS SERVICE REFORM SO IMPORTANT FOR**
5 **RURAL LOCAL EXCHANGE CARRIERS, INCLUDING ALECA MEMBERS?**

6 **A:** Switched exchange access service is provided by local exchange carriers and enables
7 end-user customers to send and/or receive long distance calls from the long distance
8 provider of their choice. (Long distance providers are also known as interexchange
9 carriers or "IXCs" on the wholesale side of the business transaction.) Per minute-of-use
10 rates charged for intrastate switched exchange access service provide revenue to the local
11 exchange carrier, which is essential to keep basic local exchange rates affordable in rural
12 Arizona.

13 **Q: YOU SPECIFICALLY MENTION INTRASTATE SWITCHED EXCHANGE**
14 **ACCESS SERVICE. IS THERE A CORRESPONDING INTERSTATE**
15 **EXCHANGE ACCESS SERVICE PROVIDED BY ALECA MEMBERS?**

16 **A:** Yes. Because of jurisdictional separations mandated by the Federal Communications
17 Commission ("FCC"), interstate switched exchange access service is governed by the
18 FCC, while this Commission regulates intrastate switched exchange access service for
19 ALECA members under its jurisdiction.

20 **Q: HAS THE FCC IMPLEMENTED INTERSTATE SWITCHED EXCHANGE**
21 **ACCESS REFORM IN THE RECENT PAST?**

22 **A:** Yes.

23 **Q: HOW HAS THE FCC REFORMED INTERSTATE SWITCHED EXCHANGE**
24 **ACCESS SERVICE FOR ALECA MEMBERS?**

1 A: Briefly, the FCC has implemented various reforms affecting interstate switched access
2 service. Most notable is the reform implemented earlier this decade, where per minute-
3 of-use interstate switched exchange access service rates were reduced.¹ These rates were
4 reduced in an attempt to reduce or eliminate implicit support embedded in the various
5 rates—support that provided essential revenues to rate-of-return local exchange carriers.
6 These revenues were used to promote the widespread availability of basic local exchange
7 services in remote areas of the nation. After these reforms, the interstate revenues
8 formerly received through interstate switched exchange access service were transferred
9 either to an explicit federal universal service program or to increase the federal end-user
10 common line charge. Thus, rural carriers were able to receive the same level of revenues
11 they would have received before these reforms.

12 Q: **DID THE FCC ALSO REFORM INTERSTATE SWITCHED EXCHANGE**
13 **ACCESS RATES FOR PRICE-CAP LOCAL EXCHANGE CARRIERS LIKE**
14 **QWEST?**

15 A: Yes. Similar reforms also occurred for price-cap carriers, including rural LECs. These
16 reforms were ordered under the adoption of the “CALLS” plan.²

17 **III THE NEED FOR INTRASTATE SWITCHED ACCESS REFORM IN ARIZONA**

18 Q: **WHAT IS THE DIFFERENCE BETWEEN COMPOSITE INTERSTATE AND**
19 **INTRASTATE SWITCHED EXCHANGE ACCESS RATES?**

¹ See Multi-Association Group (MAG) Plan for Regulation of Interstate Services of Non-Price Cap Incumbent Local Exchange Carriers and Interexchange Carriers, Federal-State Joint Board on Universal Service, Access Charge Reform for Incumbent Local Exchange Carriers Subject to Rate-of-Return Regulation, Prescribing the Authorized Rate of Return for Interstate Services of Local Exchange Carriers, Second Report and Order and Further Notice of Proposed Rulemaking in CC Docket No. 00-256, Fifteenth Report and Order in CC Docket No. 96-45, and Report and Order in CC Docket Nos. 98-77 and 98-166, 16 FCC Rcd 19613 (2001).

² See Access Charge Reform, CC Docket Nos. 96-262, 94-1, 99-249, 96-45, Sixth Report and Order in CC Docket Nos. 96-262 and 94-1, Report and Order in CC Docket No. 99-249, Eleventh Report and Order in CC Docket No. 96-45, 15 FCC Rcd 12962 (2000) (CALLS Plan)

1 A: The ALECA members reported earlier this year that there difference between their
2 interstate and intrastate composite switched exchange access rates is approximately nine
3 cents per minute-of-use. This difference is an average; for some ALECA members the
4 difference is much greater than nine cents.

5 **Q: WHAT PROBLEMS ARISE WHEN THERE IS SUCH A DIFFERENCE**
6 **BETWEEN INTERSTATE AND INTRASTATE PER MINUTE-OF-USE**
7 **COMPOSITE RATES?**

8 A: Experience has shown that when there is a large difference in rates for a similar service,
9 there is a strong financial incentive for purchasers of switched exchange access services,
10 notably the IXC's, to rate intrastate calls as interstate—thereby paying a lower rate for the
11 same network function, i.e., the origination or termination of an interexchange call. This
12 activity is a type of price arbitrage that reduces the legitimate revenues a local exchange
13 carrier should receive. Therefore, the current intrastate access regime appears to be
14 contrary to the Commission's policy to preserve and promote the widespread
15 affordability of basic local exchange services throughout rural Arizona.

16 **Q: IS INTRASTATE SWITCHED EXCHANGE ACCESS SERVICE REFORM IN**
17 **THE PUBLIC INTEREST?**

18 A: Yes. My experience and observation in other states shows that intrastate access reform is
19 in the public interest and promotes the widespread affordability of basic local exchange
20 services. If switched access rates can be reduced—with a corresponding increase in
21 disbursement from a state-based high cost universal service fund—the arbitrage incentive
22 will be eliminated or reduced and rural carriers will be able to promote the widespread
23 affordability of basic local exchange services.

24 **IV THE ALECA ACCESS REFORM PROPOSAL**

1 **Q: WHAT IS ALECA'S PROPOSAL FOR INTRASTATE SWITCHED EXCHANGE**
2 **ACCESS SERVICE REFORM.**

3 A: ALECA'S proposal is quite simple and is similar to the essential component of what was
4 done in the interstate regime. The Commission should reduce each carrier's composite
5 intrastate switched exchange access rate, calculate the total revenue reduction associated
6 with this loss and compensate the carrier by funds provided from an explicit high-cost
7 universal service program. This would shift revenues received from intrastate exchange
8 access to high-cost universal service support. Its design is revenue neutral.

9 **Q: WHAT RATE DOES ALECA PROPOSE TO USE FOR THE INTRASTATE**
10 **SWITCHED EXCHANGE ACCESS COMPOSITE RATE?**

11 A: ALECA proposes to use the Qwest statewide intrastate composite rate of \$0.0220 per
12 minute-of-use.³ While this rate is higher than the estimated ALECA interstate composite
13 rate (reported to be 1.66 cents per minute-of-use), using the Qwest statewide intrastate
14 composite rate is an appropriate step in reforming Arizona's intrastate switched access
15 regime. By reducing each ALECA member composite rate to the Qwest composite rate,
16 the Commission would promote equity between urban/suburban and rural areas of the
17 state. Furthermore, since the Qwest composite rate is publically available, it provides a
18 simple and straightforward target rate for switched access reform. Lastly, using the
19 Qwest composite rate instead of the ALECA members' composite interstate rates will
20 lessen the burden of the Arizona high-cost universal service fund and corresponding
21 surcharge that may be applied to end-user bills.

22 **Q: SHOULD THE COMMISSION REQUIRE A RATE CASE FOR EACH ALECA**
23 **MEMBER TO OFFSET REVENUES LOST AS A RESULT OF LOWERING THE**
24 **INTRASTATE SWITCHED EXCHANGE ACCESS COMPOSITE RATE?**

³ Qwest Corporation's Responses to ALECA's Set One, Data Request 1.1. Qwest has lowered its intrastate per minute-of-use access rates four times over the past eight years.

1 A: No. Requiring each ALECA member to file a rate case to initialize a revenue-neutral
2 shift of access revenues would result in a very costly, long and protracted review
3 involving each of the ALECA members and would not be a wise use of the
4 Commission's resources. The Commission should instead order a revenue-neutral shift
5 of revenues from intrastate switched access to the Arizona high-cost universal service
6 fund using 2009 as the base year. The Commission should also adopt ALECA's position
7 that these high-cost fund disbursements will be frozen for at least three years—thereafter
8 it may make adjustments to these disbursements as it deems necessary.

9 **Q: SHOULD THE COMMISSION ESTABLISH A LOCAL RATE BENCHMARK AS**
10 **PART OF INTRASTATE ACCESS REFORM?**

11 A: No. Establishing a revenue benchmark is not necessary to begin intrastate switched
12 exchange access reform in Arizona. A revenue-neutral shift of revenues from intrastate
13 access to a high-cost universal service fund provides for expedited reform, without
14 adding complications related to establishing a benchmark.

15 **V ESTIMATED AUSF HIGH-COST NEEDED FOR ACCESS REFORM**
16 **PROPOSAL**

17 **Q: WHAT IS THE AMOUNT OF ANNUAL HIGH-COST DISBURSEMENT**
18 **NEEDED TO IMPLEMENT THE ALECA PROPOSAL?**

19 A: Based on 2008 data I received from each ALECA member, I have computed the
20 composite average revenue per minute-of-use for each member.⁴ By subtracting the
21 Qwest composite intrastate access rate from each rate and multiplying this difference

⁴ Using 2009 as a base year, the ALECA members can produce their intrastate switched access revenues and corresponding minutes-of-use to the Commission. These data can be used to develop a member specific composite intrastate switched access rate. The difference between this 2009 composite and the Qwest composite multiplied by the corresponding ALECA member's minutes-of-use can be used to determine the annual disbursement needed from a high-cost fund. ALECA members would file tariffs for specific rate elements that achieve the Qwest composite rate based on individualized experiences, e.g., transport facilities will be unique to each ALECA member due to mileage considerations.

1 with the total intrastate access minutes for each member, the aggregate annual amount of
2 AUSF support needed is approximately \$23 million.

3 **Q: HOW CAN THE COMMISSION CONFIRM AND FINALIZE THIS ESTIMATE?**

4 A: After establishing the AUSF high-cost program, the ALECA members will provide the
5 Commission with the data necessary to calculate the base year composite average
6 intrastate access revenue per minute-of-use for each ALECA member. Thereafter, the
7 Commission would be able to verify a member's revenue-neutral disbursement and order
8 that the disbursement be distributed monthly, after the member files revisions to its
9 intrastate switched access tariff and shows how its base-year activity with revised rates
10 produces a composite intrastate access rate equal to \$0.022 per minute-of-use.

11 **Q: HOW SHOULD AUSF HIGH-COST SUPPORT BE COLLECTED?**

12 A: The Commission should adopt a revenue-based surcharge on intrastate retail
13 communications billed revenues of all communications carriers, including LECS, IXC's,
14 wireless carriers, and interconnected VoIP service providers. Recipients of AUSF High-
15 Cost support should be reimbursed for their contributions by adding their contribution
16 amount to their disbursement amount. This will ensure that net support received through
17 disbursements is equal to the amount of intrastate revenue shifted from the intrastate
18 switched exchange access regime to the AUSF High-Cost program.

19 **VI ARIZONA HIGH-COST LOOP SUPPORT**

20 **Q: SHOULD THE AUSF BE USED TO PROVIDE HIGH-COST LOOP SUPPORT?**

21 A: Yes. I recommend a portion of the AUSF support be based on the cost model used to
22 calculate Federal High-Cost Loop Support (HCLS). The federal HCLS uses an algorithm
23 that calculates a company's Study Area Cost Per Loop (SACPL) based on the actual
24 investment, expenses, and loops of the company. The SACPL is then compared to the
25 national average cost per loop (NACPL) and the ILEC receives federal support for a

1 portion costs exceeding 115 percent of the NACPL. The information from the federal
2 HCLS algorithm is readily available and can be used to develop a state mechanism that
3 complements the federal HCLS mechanism.

4 **Q: WHAT MECHANISM DO YOU PROPOSE FOR THE ARIZONA HIGH-COST**
5 **LOOP SUPPORT?**

6 **A:** ALECA proposes the Commission adopt rules establishing support for loop costs that
7 exceed the current federally determined qualification thresholds. Carriers are presently
8 eligible for federal HCLS when SACPL loop costs exceed 115 percent of the NACPL.
9 Costs in excess of 115 percent, but less than 150 percent, are eligible for 65 percent
10 federal recovery. Costs in excess of 150 percent are eligible for 75 percent federal
11 recovery. The ALECA proposal would complement this federal support by providing
12 support for the remaining portion of eligible high loop costs. Specifically, for carriers
13 who receive 65 percent federal cost recovery, the State would provide a 35 percent cost
14 recovery. For carriers who receive 75 percent federal recovery of loop costs in excess of
15 the NACPL, the state would provide support of 25 percent for any loop costs in excess of
16 150 percent.

17 This state support would be in addition to a revenue-neutral draw from the AUSF to
18 offset intra-state access reductions. ALECA's members serve rural and remote areas of
19 Arizona. Low customer density makes ALECA's members and their customers
20 dependent on high-cost support mechanisms. There are three revenue streams available
21 to the rural ILECs: local service revenues, access revenues, and universal service support.
22 ALECA's members do not have a large enough customer base to recover a sufficient
23 amount of revenue to cover the cost of providing local service. Local service revenues
24 and access revenues, which have been designed to keep local service rates affordable,
25 would be used to recover loop costs that do not exceed the 115 percent NACPL

1 threshold. All loop costs above this threshold would be recovered through either the
2 existing federal HCLS mechanism or through the new state high-cost loop mechanism.
3 ALECA proposes a high-cost loop mechanism that allows using the federal calculation in
4 Arizona.

5 **Q: HAVE YOU ESTIMATED THE AMOUNT OF ARIZONA HIGH-COST LOOP**
6 **SUPPORT THAT WOULD BE NEEDED FOR THIS NEW PROGRAM?**

7 **A:** Yes. I have used 2007 federal HCL disbursements and for estimation purposes, I have
8 assumed that federal support has been received under the 65 percent cost recovery
9 mechanism. Based on this information, the remaining 35 percent required under the
10 Arizona high cost loop mechanism would be approximately \$9 million. Upon adoption
11 of the rules, the ALECA members will provide specific amounts to the Commission that
12 would provide an exact amount that the Arizona high cost loop mechanism would
13 provide. The \$9 million estimate is higher than what would be needed to the extent that
14 some carriers have costs in excess of the 150 percent federal threshold and have federal
15 recovery at 75 percent. For every dollar recovered from the federal HCL at 75 percent
16 instead of 65 percent, the requirements of the Arizona fund would decline.

17 **VII LIFELINE AND LINK-UP**

18 **Q: SHOULD THE AUSF BE USED FOR ANY OTHER PURPOSES?**

19 **A:** Yes. I recommend that the Commission adopt the proposals contained in the Report and
20 Recommendations of the Eligible Telecommunications Carriers (ETCs) on Lifeline and
21 Link-Up Issues, docketed December 21, 2005. In this report, the ETCs recommended
22 that the Department of Economic Security (DES) centrally administer the Lifeline and
23 Link-Up programs of all of Arizona's ETCs and that the DES be reimbursed for the
24 administrative costs incurred from the AUSF. Centralized administration enables

1 automatic enrollment, and as the ETCs recognized, automatic enrollment is a very
2 effective, if not the most effective, form of outreach.

3 **VIII PROPOSED AUSF RULES**

4 **Q: HAVE YOU ATTACHED THE PROPOSED RULES TO YOUR TESTIMONY?**

5 A: Yes. I have included ALECA's proposed rules, which would implement the
6 recommendations that I have just discussed. Exhibit DDM-01 is a clean version of the
7 AUSF rule proposed by ALECA, which incorporates the proposed access reforms.
8 Exhibit DDM-02 is a redline version of the proposed AUSF rule, which shows changes
9 from the existing rules. Finally, Exhibit DDM-03 contains a proposed AUSF rule for the
10 lifeline and linkup provisions discussed above and referenced in the 2005 ETC report.

11 **IX SUMMARY**

12 **Q: IS THE ADOPTION OF THE ALECA PROPOSALS IN THE PUBLIC**
13 **INTEREST?**

14 A: Yes. The reform of intrastate switched access service rates as described will help align
15 the wholesale industry to promote the public interest in the retail offerings of multiple
16 carrier groups. Long distance providers, as well as wireless providers who pay for access
17 services, will see reductions in their costs. Since these markets are generally very
18 competitive, their end-user customers will likely see reductions in service prices when
19 switched access service is used as an input. Moreover, billing disputes at the wholesale
20 level will likely be reduced as there will be less incentive to engage in price arbitrage.
21 High-cost loop support will further support rural Arizona carriers' efforts to provide
22 affordable, reliable service to their constituents. Finally, the lifeline and link-up
23 administration reform will encourage outreach, which will lead to increases in
24 participation by end-users in these vital low-income programs.

1 Q: DOES THIS CONCLUDE YOUR DIRECT TESTIMONY?

2 A: Yes.

Direct Testimony of Douglas Duncan Meredith
Arizona Corporation Commission
December 1, 2009
Exhibit DDM-01

ARTICLE 12. ARIZONA UNIVERSAL SERVICE FUND

R14-2-1201 Definitions

In this Article, unless the context otherwise requires, the following definitions shall apply:

1. **"Administrator"** is the person designated pursuant to R14-2-1212 to administer the AUSF and perform the functions required by this Article.
2. **"Arizona Corporation Commission"** or **"Commission"** is the regulatory agency of the state of Arizona having jurisdiction over public service corporations operating in Arizona.
3. **"Arizona Universal Service Fund"** or **"AUSF"** is the funding mechanism established by this Article through which surcharges are collected and support paid in accordance with this Article.
4. **"AUSF Support"** is the amount of money, calculated pursuant to this Article, which a provider of basic local telephone exchange service is eligible to receive from the AUSF pursuant to this Article.
5. **"AUSF Support Area"** is the geographic area for which a local exchange carrier's eligibility to receive AUSF support is calculated.
6. **"Basic" local exchange telephone service** is telephone service that provides the following features:
 - a. Access to 1-party residential service with a voice grade line;
 - b. Access to touchtone capabilities;
 - c. Access to an interexchange carrier;
 - d. Access to emergency services, including but not limited to emergency 911;
 - e. Access to directory assistance service;
 - f. Access to operator service;
 - g. Access to a white page or similar directory listing; and
 - h. Access to telephone relay systems for the hearing and speech impaired.
7. **"Basic local exchange rate"** means an incumbent local exchange carrier's tariffed, monthly, single-line flat rate charged to its retail customers for the provision of local exchange service.
8. **"Benchmark rates"** for a telecommunications services provider are those rates approved by the Commission for that provider for basic local exchange telephone service, plus the Customer Access Line Charge approved by the Federal Communications Commission.
9. **"Commercial Mobile Radio Service"** is any radio communication service carried on between mobile stations or receivers and land stations, or by mobile stations communicating among themselves, that is provided for profit and that makes available to the public service that is connected to the public switched network.
10. **"Eligible telecommunications carrier (ETC)"** means an entity with Arizona operations that provides retail telecommunications services that has been designated by the

Commission as eligible to receive disbursements from the AUSF or from the federal universal service fund

11. **"Intrastate retail telecommunications revenue"** means the revenue collected from the sale of intrastate telecommunications services to end users for voice over internet protocol (VOIP) and similar services. (The portion of total retail revenues attributable to intrastate retail telecommunications shall be equal to the proportion of calls originating and terminating in Arizona to all calls originating in Arizona)
12. **"Intrastate retail telecommunications services"** means services including, but not limited to: all types of local exchange service; non-basic, vertical or discretionary services, also known as advanced features, or premium services, such as, but not limited to, call waiting, call forwarding, and caller ID; listing services; directory assistance services; cellular telephone and paging services; commercial mobile radio services; personal communications services (PCS); both optional and non-optional operator services; wide area telecommunications services (WATS) and WATS-like services; toll-free services; 900 services and other informational services; message telephone services (MTS or toll; CENTREX, Centron and Centron-like services; video conferencing and teleconferencing services; the resale of intrastate telecommunications services; payphone services; services that provide telecommunications through an Arizona telephone number using voice over internet protocol (VOIP) or comparable technologies; any services regulated by the Commission; and such other services as the Commission may by order designate from time to time as equivalent or similar to the services listed above, without regard to the technology used to deliver such services;
13. **"Large Local Exchange Carriers"** are incumbent providers of basic local exchange telephone service serving more than 200,000 access lines in Arizona.
14. **"Small Local Exchange Carriers"** are incumbent providers of basic local exchange telephone service with 200,000 or fewer access lines in Arizona.
15. **"Telecommunications Service Provider"** means any carrier that provides intrastate retail public telecommunications services or comparable retail alternative services in Arizona, including but not limited to incumbent local exchange carriers, interexchange carriers, wireless carriers, and carriers providing fixed or nomadic service utilizing voice over internet protocol.
16. **"Total Service Long Run Incremental Cost"** is the total additional cost incurred by a telecommunications company to produce the entire quantity of a service, given and the telecommunications company already provides all of its other services. Total Service Long Run Incremental Cost is based on the least cost, most efficient technology that is capable of being implemented at the time the decision to provide the service is made.
17. **"U.S. Census Blocks"** are geographic areas defined by the U.S. Department of Commerce. The areas, which define the way in which census data is aggregated, generally contain between 250 and 550 housing units.

R14-2-1202
Calculation of AUSF High-Cost Loop Support

- A. An ETC shall be eligible to receive High Cost Loop Support (HCLS) for a given AUSF support area. For small local exchange carriers, the algorithm used to determine federal HCLS, which calculates loop cost in excess of 115% of the national average, shall be used as the basis for calculating state HCLS. For ETCs that receive federal HCLS, the AUSF shall provide the ETC an amount equal to the unreimbursed loop costs in excess of 115% of the national average.
- B. For a small local exchange carrier, the AUSF support area shall be identical to the support area or areas as identified by the FCC for federal USF. The appropriate cost of providing basic local exchange telephone service for purposes of determining AUSF support for a small local exchange carrier shall be the embedded cost of the incumbent provider
- C. For a large local exchange carrier, the AUSF support area shall be U.S. census block groups, and the appropriate cost of providing basic local exchange telephone service for purposes of determining AUSF support shall be the Total Service Long Run Incremental Cost. In the event that the FCC adopts a somewhat different forward-looking costing methodology and/or a different geographic study/support area for the Federal universal service fund program, a local exchange carrier may request a waiver from this rule in order to utilize the same cost study methodology and/or geographic study areas in both jurisdictions. Any request for AUSF support by a large local exchange carrier shall include a Total Service Long Run Incremental Cost study, or cost study based on FCC adopted methodology, of basic local exchange service. The cost study shall be developed and presented in a manner that identifies the cost for the individual support areas for which AUSF funding is being requested.

R14-2-1202(A)
Calculation of Revenue Neutral AUSF Support

- A. Effective January 1, 2011, a local exchange carrier's intrastate switched access charges may not exceed its historical access rate, less one-half of the difference between its historical access rate and Qwest's composite intrastate switched access rate.
- B. Effective January 1, 2012, a local exchange carrier's intrastate switched access charges may not exceed Qwest's composite intrastate switched access rate.
- C. Prior to October, 1 2010, each local exchange carrier shall submit to the administrator and the Commission the schedule of its intrastate access charge rate reductions in conformity with this rule and shall submit to the Commission proposed tariff revisions reflecting the schedule of rate reductions and other changes necessary to assure that, upon completion of the reductions, all tariffed intrastate switched access charge elements and structure will match Qwest's composite intrastate switched access rate. Included in this schedule of proposed reductions, each local exchange carrier shall submit a report containing their originating and terminating intrastate minutes-of-use for the calendar year 2009 (base year) and its calculation of AUSF support to be received under its proposed schedule filed under this section. Prior to November 1, 2010, the administrator shall issue its recommendation to the Commission regarding each local

exchange carrier's schedule of its intrastate access charge rate reductions and corresponding AUSF support based on 2009 (base year) data. Prior to December 1, 2010, the Commission shall approve or deny each carrier's proposed reductions and AUSF support amounts,

- D. After receipt of Commission approval, the administrator shall calculate the monthly amount of AUSF support for each carrier and begin distribution of AUSF support provided for under this section. Monthly disbursements shall commence January 2011. Monthly disbursements under this section for each carrier shall remain fixed until an order mandating the revision of AUSF support is received under this section. Notwithstanding, no revisions to AUSF support received under this section shall occur until January 1, 2014.
- E. On or after January 1, 2014, the Commission, on its own motion or on the motion of a party or the administrator, may order the revision of a local exchange carrier's intrastate access charge rate reduction schedule and corresponding AUSF support received under this section.
- F. The Commission may, upon motion of a carrier or the administrator, or upon the Commission's own motion, authorize further intrastate switched access charge reductions for a carrier to correspond to any changes in Qwest's intrastate switched access service charge rates, elements or structure subsequent to January 1, 2011. Such changes to rates, elements or structure would continue to use 2009 (base year) minutes-of-use of each carrier in calculating the amount of AUSF support provided for under this section.

R14-2-1202(B)
Facility Extension Requests

A. Applications for Distribution:

- (1) Potential customers not presently receiving basic local service because facilities are not available may apply to the Commission for distribution from the fund for extension of service to themselves or to a group of customers.
- (2) Those distributions are to be approved by the Commission, and made only in circumstances where traditional methods of funding and service provision are infeasible.
- (3) Distributions will not be made for customers who are not full time residents.
- (4) An application for a distribution may be filed with the Commission by an individual or group of consumers desiring telephone service, a telecommunications corporation on behalf of those consumers, the Commission staff, or any entity permitted by law to request agency action. An application shall identify the service(s) requested, the area to be served and the individuals or entities that will be served if the distribution is approved.
- (5) Following the application's filing, the affected telecommunications corporations shall provide any pertinent information requested by the Commission Staff including

engineering, facilities and cost information that will assist in the Commission's consideration of the application.

- (6) In considering the application, the Commission will examine relevant facts including the type and grade of service to be provided, the cost of providing the service, the demonstrated need for the service, whether the customer is within the service territory of a telecommunications corporation, whether the proposed service is for a primary full time residence and other relevant factors to determine whether the one-time distribution is in the public interest.

B. Presumed reasonable amounts and terms:

- (1) Unless otherwise ordered by the Commission, the maximum distribution will be no more than \$25,000 per customer. The Commission will presume a wireline company's service or line extension terms and conditions reasonable for a subscriber connection with universal service fund distribution requests, if the costs of service extension are recovered as follows:
 - a. The first \$500 of cost coverage is provided by the company, and
 - b. For cost amounts exceeding the \$500 level, up to two times the statewide average loop investment for all regulated companies as determined annually by the Commission, equally provided by the company and the customer.
- (2) When the Commission approves an application for the use of AUSF: 95 percent of service extension costs above those recovered through the service extension cost recover terms specified above, shall be paid through AUSF, up to the maximum universal service fund expenditure levels specified by this rule. The remaining five percent or any additional amounts shall be paid by additional customer contributions beyond those specified above.
- (3) Potential customers in the area shall be notified by the telecommunications corporation of the nature and extent of the proposed service extension, the Commission's approval of the application, and the necessary customer contribution amounts to participate in the project. Customer contribution payments shall be made prior to the start of construction.
- (4) Within five years following approval of the application, any customer that seeks telecommunications service in the project area serviceable by an AUSF-funded loop drop shall pay a customer contribution equal to the original customer contributions in the project. Funds received through these payments shall be sent to the AUSF administrator.
- (5) For each customer added during the five-year period following project completion, the telecommunications corporation and new customers shall bear the costs to extend service pursuant to the company's service or line extension terms and conditions and up to the telecommunications corporation's original contribution per customer for the project and the customer contribution required by this rule. The company may petition the Commission for a determination of the recovery from universal service fund and the new customer for costs which exceed this amount.

- (6) Impact of distribution on Companies – A distribution from the fund under this subsection shall be recorded on the books of a regulated LEC as an aid to construction and treated as an offset in rate base.
- (7) Notice and Hearing – Following notice that a distribution application has been filed any interested party may request a hearing or seek to intervene to protect its interest.
- (8) Bidding for Unserved Areas – If only one telecommunications corporation is involved in the distribution request, the distribution will be provided based upon the actual costs of that company. If additional telecommunications corporations are involved, the distribution will be determined on the basis of a competitive bid. The estimated amount of the distribution will be considered in evaluating each bid. Fund distributions in that area will be based on the winning bid.

R-14-2-1203
Request for AUSF Support

A provider of basic local exchange telephone service may request that the Commission authorize AUSF support with a filing under R14-2-103, R14-2-1202(A), R14-2-1202(B), or other method as the Commission may prescribe, and upon compliance with all applicable rules set forth in R14-2-1101 through R14-2-1115. A request for AUSF support shall include a statement describing the need for such funding. The Commission shall determine the appropriate cost of providing basic local exchange service for each AUSF support area for which AUSF support is requested and shall calculate in accordance with R14-2-1202 the amount of AUSF support, if any, to which the applicant is entitled. A provider of basic local exchange telephone service may request that the Commission authorize Revenue Neutral AUSF support, after fulfilling the requirements in Section R14-2-1202(A).

R14-2-1204
Funding of the AUSF

The AUSF shall be funded in accordance with this Article by all telecommunications service providers that interconnect to the public switched network. Within 30 days of the effective date of this Article, and thereafter on or before October 1 of each year, each telecommunications provider shall provide to the Administrator a list of all other telecommunications providers that interconnect to its facilities or network.

R14-2-1205
Determination of AUSF Surcharge Rate and Contribution

- A. The administrator, or the Commission, shall determine the state USF surcharge rate annually, on or before November 1 of each year, in sufficient time for contributions to be paid into and disbursements to be made from the fund. The surcharge rate will be based upon monthly and annual reports filed by ETCs, local exchange carriers eligible for revenue-neutral AUSF support pursuant to R14-2-1202(A), and contributing companies, and any other pertinent and reliable information available to the administrator or the Commission.

- B. Upon its determination of a USF surcharge rate, the administrator shall notify all contributing companies, ETCs, and the Commission. The rate determined by the administrator shall go into effect unless modified or disapproved by the Commission.
- C. The surcharge rate shall be equal to the annual fund requirement divided by the sum of intrastate retail telecommunications revenue for all contributing carriers in Arizona, and may be adjusted to account for any material deficit or surplus projected to exist at the start of the fund year.
- D. Each contributing company's monthly contribution shall equal the state USF surcharge rate multiplied by its intrastate retail telecommunications revenues in Arizona for the month.
- E. If, for any month the administrator finds that the fund balance is insufficient to cover required disbursements plus administrative expenses including audit fees, the administrator may, with the Commission's approval, increase contribution requirements to make up the shortfall. If the fund accumulates a surplus beyond what the administrator and the Commission believe is prudent under the circumstances, the administrator may, with the Commission's approval, decrease contribution requirements so as to lower the fund balance to an appropriate level.
- F. Each contributing company shall remit its monthly contribution to the administrator on a schedule to be determined by the administrator

**R14-2-1206
Implementation**

- A. Any provider of telecommunications service may file either an AUSF tariff or price list, if appropriate, establishing a flow-through mechanism to collect the surcharge approved by the Commission and calculated by the Administrator.
- B. On or before the 20th day of each month, each telecommunication service provider responsible for collecting AUSF surcharges shall remit to the Administrator the AUSF surcharge, collected by that telecommunications service provider during the preceding month. The telecommunications service provider shall submit such documentation of AUSF revenues from the AUSF surcharge as may be required by the Administrator.
- C. Eligible recipients of AUSF support are:
 - (1) Providers of telecommunications service engaged in providing basic local exchange telephone service in Arizona which have obtained a Commission order authorizing payments from the AUSF;
 - (2) Local exchange carriers eligible for revenue-neutral support based upon the provisions of R14-2-1202(A); and
 - (3) Providers that become entitled to AUSF support based upon the provisions of R14-2-1206(E).
- D. If the Commission approves AUSF support to a provider of telecommunications service for a defined area, such AUSF support shall also be available to competitive providers of basic

local exchange service in the same defined area that are contributing to the AUSF, and that are willing to provide service to all customers in the specific AUSF support area as defined by the Commission. The AUSF support to which the competitive provider is eligible shall be calculated based on the competitive carriers cost on a per-customer basis, but shall not result in an increase in the total cost based AUSF support available for the specific census block groups or study area. If basic exchange service is provided through the resale of another carrier's local loop facilities, AUSF based support will only be available to the retail service provider if AUSF support is not included in the wholesale price for the resold local service. This Section shall not apply to small local exchange carriers or to the universal service support being received by any telecommunications service provider as of the effective date of this Article.

- E. For small local exchange carriers and for any basic local exchange telephone service provider receiving universal service support as of the effective date of this Article, the AUSF cost based support shall not be available to competitive providers of basic local exchange service prior to completion of the review provided for in R14-2-1216. Following completion of the review, AUSF cost based support provided to small local exchange carriers shall be available to all competitive eligible telecommunications carriers providing basic local exchange service in the defined area and contributing to AUSF, and that are willing to provide service to all customers in the specific geographic study area as defined by the Commission, unless otherwise ordered by the Commission.
- F. Defined area, study area, geographic area, and support area mean the same area during the first three years of the effective date of this Article. After the first three years, they will still have the same meaning unless otherwise ordered by the Commission.

R14-2-1207

Calculation of Monthly Payments and the Associated Collections

- A. The monthly AUSF payment that each Telecommunications Service Provider shall remit to the Administrator is an amount equal to its total monthly intrastate revenue times the monthly surcharge percentage.
- B. Payments must be received by the Administrator by the 20th day of each month. If the payment amount is greater than \$10,000, then it shall be wire transferred to the Administrator.
- C. The Administrator shall enter into an appropriate non-disclosure agreement with each telecommunications service provider to assure that information necessary to allocate AUSF funding obligations and to calculate surcharges is reported, maintained, and used in a manner that will protect the confidentiality of company specific data. The Administrator shall not use confidential data for any purpose other than administering the AUSF.

R14-2-1208

Monthly AUSF Disbursements

- A. AUSF disbursement shall be made 30 days following the date of AUSF collections.

- B. The Administrator shall not make AUSF support payments to a provider of telecommunications service until the Administrator has received a copy of a Commission decision authorizing the provider to receive such support.

R14-2-1209

Procedures for Handling AUSF Rate Changes

- A. AUSF surcharges shall be revised when the Commission authorizes new or revised AUSF payments to any provider of telecommunications service. The Administrator shall calculate the new AUSF flow-through surcharges in accordance with this Article, which surcharge shall become effective upon the Commission's approval of the new or revised AUSF payments.
- B. An annual calculation to revise AUSF flow-through surcharges shall be made by the Administrator on December 1 of each year with an effective date the following January 1. The flow-through surcharges shall be calculated so that the total AUSF funding will equal the AUSF revenue requirements plus administrative costs including audit fees as well as any corrections and true-ups. No later than December 1 of each year, the Administrator shall provide notice to the Commission and all telecommunication service providers who pay into the AUSF of the flow-through surcharge rates for the following calendar year.

R14-2-1210

Statement of Participation of All Telecommunications Service Providers in the AUSF

- A. Within 30 days of the effective date of this Article, each telecommunications service provider shall provide a letter to the Administrator acknowledging that provider's obligation under this Article to pay AUSF surcharges. Failure to provide such a letter shall be grounds for termination after written notice from the Administrator of the provider's interconnection with the public switched network.
- B. Any telecommunications service provider which begins providing telecommunications service after the effective date of this Article shall, within 30 days of beginning to provide intrastate service in Arizona, provide a letter to the Administrator acknowledging that provider's obligation under this Article to make monthly payments for the local and/or toll portion, as appropriate, of the AUSF contribution in accordance with this Article. Failure to provide such a letter shall be grounds for denying to the provider interconnection with the public switched network.

R14-2-1211

Duties and Responsibilities of the AUSF Administrator

The Administrator shall:

- (1) Develop, obtain, and, on or before December 15 of each year, file with the Commission such information and documentation as the Administrator deems necessary for the establishment and calculation of the surcharges for the succeeding year. Such a filing

shall also be made each time the Commission authorizes a change in the AUSF funding requirement.

- (2) Monitor the AUSF payments of all telecommunications providers.
- (3) Oversee the billing of AUSF surcharges.
- (4) Prepare the necessary forms to be used in reporting the AUSF collections and disbursements and maintain monthly records.
- (5) Coordinate the collection and disbursement of AUSF monies in accordance with this Article.
- (6) Prepare an annual report that provides a detailed accounting of the AUSF collections and disbursements and that identifies the annual cost of administration. The report shall be filed with the Commission on or before April 15 of each year.
- (7) Monitor procedures for auditing the AUSF collections and disbursements. The audit function shall be performed by an independent outside auditor.
- (8) Oversee reimbursement of the responsible agency's costs of administering Lifeline and Link-Up programs of Eligible Telecommunications Carriers pursuant to Article 22.

R14-2-1213

Guidelines for Auditing the AUSF

- A. The AUSF records covering both collections and disbursements shall be audited at the end of the first year following the designation of a third party administrator. The AUSF records will then be audited at least once every other year in the subsequent years of operations.
- B. The records shall be examined for accuracy and the existence of effective internal controls to ensure that the AUSF is being administered appropriately and properly.
- C. An independent external auditor selected by the Commission shall be utilized to provide an unbiased audit opinion concerning the AUSF administration procedures and controls.
- D. Any costs for conducting audits will be deducted from the revenues of the AUSF prior to disbursement of funds.

R14-2-1214

Enforcement of Collection of Delinquent AUSF Amounts

- A. The Administrator shall issue past due notices to each provider of telecommunications service that is 15 days or more delinquent in submitting its AUSF payments to the Administrator. A copy of this notice shall be provided to the Commission.
- B. AUSF support payments shall be withheld from any provider of telecommunications service that is delinquent in submitting its AUSF payments to the Administrator. Each provider of telecommunications service will be fully liable for any accrued interest owing on its AUSF contributions that remain unpaid for 30 days. Such delinquent AUSF payments will begin

accruing interest at the rate of 1 and ½% per month beginning with the 31st day until such amount is paid in full along with all accrued interest.

- C. Failure by the Telecommunications service provider to comply with the provisions of this Article any result in sanctions as determined by the Commission.

**R14-2-1215
AUSF Annual Report**

- A. On or before April 1 of each year, the Administrator shall file with the Commission an annual report which shall summarize the preceding year activity and contain the following:
 - (1) A statement of AUSF collections and disbursements.
 - (2) A record of the total cost of administration of the AUSF.
 - (3) Audit reports from the audits conducted during the year.
- B. A copy of the annual report shall be provided to each provider of telecommunications service who contributes to the AUSF.

**F14-2-1216
Review Process**

- A. Three years from the effective date of this Article, the Commission may consider the necessity of a comprehensive review of this Article. Upon recommendation from the Commission, the Commission staff shall initiate such review of this Article and shall provide the Commission with recommendations regarding any necessary changes to the Article. The Commission shall consider these recommendations in such proceeding as the Commission deems appropriate.
- B. The costs used to calculate AUSF funding levels for a given provider or AUSF support area may be reviewed by the Commission at least every three years following the effective date for any authorized AUSF support for the provider or study area. The Commission may reduce the authorized funding level and require that the AUSF surcharge be recalculated on the basis of this review.

**F14-2-1217
Supersession of Existing USF Mechanism**

The universal service funding mechanism initially approved by the Commission in Decision No. 56639 (September 22, 1989) is superseded by this Article, except that any calculation, contribution or collection of, or entitlement to, universal service fund support approved by the Commission prior to the adoption of this Article shall remain in effect until otherwise ordered by the Commission or until the Application of this Article leads to a different result.

Direct Testimony of Douglas Duncan Meredith
Arizona Corporation Commission
December 1, 2009
Exhibit DDM-02

ARTICLE 12. ARIZONA UNIVERSAL SERVICE FUND

R14-2-1201 Definitions

In this Article, unless the context otherwise requires, the following definitions shall apply:

1. **"Administrator"** is the person designated pursuant to R14-2-1212 to administer the AUSF and perform the functions required by this Article.
2. **"Arizona Corporation Commission" or "Commission."** is the regulatory agency of the state of Arizona having jurisdiction over public service corporations operating in Arizona.
3. **"Arizona Universal Service Fund" or "AUSF"** is the funding mechanism established by this Article through which surcharges are collected and support paid in accordance with this Article.
4. **"AUSF Support"** is the amount of money, calculated pursuant to this Article, which a provider of basic local telephone exchange service is eligible to receive from the AUSF pursuant to this Article.
5. **"AUSF Support Area"** is the geographic area for which a local exchange carrier's eligibility to receive AUSF support is calculated.
6. **"Basic" local exchange telephone service** is telephone service that provides the following features:
 - a. Access to 1-party residential service with a voice grade line;
 - b. Access to touchtone capabilities;
 - c. Access to an interexchange carrier;
 - d. Access to emergency services, including but not limited to emergency 911;
 - e. Access to directory assistance service;
 - f. Access to operator service;
 - g. Access to a white page or similar directory listing; and
 - h. Access to telephone relay systems for the hearing and speech impaired.
7. **"Basic local exchange rate"** means an incumbent local exchange carrier's tariffed, monthly, single-line flat rate charged to its retail customers for the provision of local exchange service.
- 7.8. **"Benchmark rates"** for a telecommunications services provider are those rates approved by the Commission for that provider for basic local exchange telephone service, plus the Customer Access Line Charge approved by the Federal Communications Commission.
- 8.9. **"Commercial Mobile Radio Service"** is any radio communication service carried on between mobile stations or receivers and land stations, or by mobile stations communicating among themselves, that is provided for profit and that makes available to the public service that is connected to the public switched network.
9. **"Conversion Factor"** is a multiplier that is used to convert a quantity of interconnecting trunks for both wireless and wireline customers into equivalent access lines, for the sole

purpose of developing Category 1 surcharges. The value of the Conversion Factor shall be 10 until completion of the review provided for in R14-2-1216.

10. "Interconnecting Trunk" is a 1-way or 2-way voice grade or equivalent voice grade switched message transmission channel furnished by a local switched access provider to a provider of wireless services or to a wireline customer of such local switched access provider to interconnect the provider of wireless service or wireline customer to the public switched network.
11. "Intermediate Local Exchange Carriers" are incumbent providers of basic local exchange telephone service with more than 20,000 access lines but fewer than 200,000 access lines in Arizona.

12.

10. "Eligible telecommunications carrier (ETC)" means an entity with Arizona operations that provides retail telecommunications services that has been designated by the Commission as eligible to receive disbursements from the AUSF or from the federal universal service fund

11. "Intrastate retail telecommunications revenue" means the revenue collected from the sale of intrastate telecommunications services to end users for voice over internet protocol (VOIP) and similar services. (The portion of total retail revenues attributable to intrastate retail telecommunications shall be equal to the proportion of calls originating and terminating in Arizona to all calls originating in Arizona)

12. "Intrastate retail telecommunications services" means services including, but not limited to: all types of local exchange service; non-basic, vertical or discretionary services, also known as advanced features, or premium services, such as, but not limited to, call waiting, call forwarding, and caller ID; listing services; directory assistance services; cellular telephone and paging services; commercial mobile radio services; personal communications services (PCS); both optional and non-optional operator services; wide area telecommunications services (WATS) and WATS-like services; toll-free services; 900 services and other informational services; message telephone services (MTS or toll; CENTREX, Centron and Centron-like services; video conferencing and teleconferencing services; the resale of intrastate telecommunications services; payphone services; services that provide telecommunications through an Arizona telephone number using voice over internet protocol (VOIP) or comparable technologies; any services regulated by the Commission; and such other services as the Commission may by order designate from time to time as equivalent or similar to the services listed above, without regard to the technology used to deliver such services;

9.13. "Large Local Exchange Carriers" are incumbent providers of basic local exchange telephone service serving more than 200,000 or more access lines in Arizona.

10.14. 13. "Small Local Exchange Carriers" are incumbent providers of basic local exchange telephone service with 20,000 or fewer access lines in Arizona.

14.

15. "Telecommunications Service Provider" means any carrier that provides intrastate retail public telecommunications services or comparable retail alternative services in Arizona, including but not limited to incumbent local exchange carriers, interexchange carriers, wireless carriers, and carriers providing fixed or nomadic service utilizing voice over internet protocol.

| 44.16. **"Total Service Long Run Incremental Cost"** is the total additional cost incurred by a telecommunications company to produce the entire quantity of a service, given and the telecommunications company already provides all of its other services. Total Service Long Run Incremental Cost is based on the least cost, most efficient technology that is capable of being implemented at the time the decision to provide the service is made.

| 42.17. 45. **"U.S. Census Blocks"** are geographic areas defined by the U.S. Department of Commerce. The areas, which define the way in which census data is aggregated, generally contain between 250 and 550 housing units.

Historical Note

~~Adopted effective April 26, 1996, under an exemption as determined by the Arizona Corporation Commission (Supp. 96-2).~~

R14-2-1202
Calculation of AUSF High-Cost Loop Support

A. ~~The amount of AUSF support to which a provider of basic local exchange telephone service is eligible for a given AUSF support area shall be based upon the difference between the benchmark rates for basic local exchange telephone service provided by the carrier, and the appropriate cost to provider basic local exchange telephone service as determined by the Commission, net of any universal service support from federal sources.~~

A. B. For a An ETC shall be eligible to receive High Cost Loop Support (HCLS) for a given AUSF support area. For small local exchange carriers, the algorithm used to determine federal HCLS, which calculates loop cost in excess of 115% of the national average, shall be used as the basis for calculating state HCLS. For ETCs that receive federal HCLS, the AUSF shall provide the ETC an amount equal to the unreimbursed loop costs in excess of 115% of the national average.

B. For a small local exchange carrier, the AUSF support area shall include all exchanges served by the local exchange carrier in Arizona be identical to the support area or areas as identified by the FCC for federal USF. The appropriate cost of providing basic local exchange telephone service for purposes of determining AUSF support for a small local exchange carrier shall be the embedded cost of the incumbent provider. For any request for AUSF support by a small local exchange carrier filed more than three years after the effective date of this Article, the AUSF support area shall be the geographic areas as determined by the Commission.

C. For any intermediate local exchange carrier, the AUST support area shall be either all exchanges in Arizona served by the carrier, or such other support area as may be approved by the Commission. The appropriate cost of providing basic local exchange telephone service for purposes of determining AUSF support for an intermediate local exchange carrier shall be the embedded cost of the incumbent provider. For any request for AUSF support by an intermediate local exchange carrier filed more than three years after the effective date of this Article, the AUSF support area shall be geographic area as determined by the Commission, and the appropriate cost of providing basic local exchange telephone service for purposes of determining AUSF support shall be the Total Service Long Run Incremental Cost of the incumbent provider. In the event that the FCC adopts a somewhat different forward-looking costing methodology and/or a different geographic study/support area for the Federal universal service fund program, a local exchange carrier may request a waiver from this rule in order to utilize the same cost study methodology and/or geographic study areas in both jurisdictions.

D. _____

C. For a large local exchange carrier, the AUSF support area shall be U.S. census block groups, and the appropriate cost of providing basic local exchange telephone service for purposes of determining AUSF support shall be the Total Service Long Run Incremental Cost. In the event that the FCC adopts a somewhat different forward-looking costing methodology and/or a different geographic study/support area for the Federal universal service fund program, a local exchange carrier may request a waiver from this rule in order to utilize the same cost study methodology and/or geographic study areas in both jurisdictions. Any request for AUSF support by a large local exchange carrier shall include a Total Service Long Run Incremental Cost study, or cost study based on FCC adopted methodology, of basic local exchange service. The cost study shall be developed and presented in a manner that identifies the cost for the individual support areas for which AUSF funding is being requested.

Historical Note

Adopted effective April 26, 1996, under an exemption as determined by the Arizona Corporation Commission (Supp.96-2).

R14-2-1202(A)
Calculation of Revenue Neutral AUSF Support

- A. Effective January 1, 2011, a local exchange carrier's intrastate switched access charges may not exceed its historical access rate, less one-half of the difference between its historical access rate and Qwest's composite intrastate switched access rate.
- B. Effective January 1, 2012, a local exchange carrier's intrastate switched access charges may not exceed Qwest's composite intrastate switched access rate.
- C. Prior to October 1, 2010, each local exchange carrier shall submit to the administrator and the Commission the schedule of its intrastate access charge rate reductions in conformity with this rule and shall submit to the Commission proposed tariff revisions reflecting the schedule of rate reductions and other changes necessary to assure that, upon completion of the reductions, all tariffed intrastate switched access charge elements and structure will match Qwest's composite intrastate switched access rate. Included in this schedule of proposed reductions, each local exchange carrier shall submit a report containing their originating and terminating intrastate minutes-of-use for the calendar year 2009 (base year) and its calculation of AUSF support to be received under its proposed schedule filed under this section. Prior to November 1, 2010, the administrator shall issue its recommendation to the Commission regarding each local exchange carrier's schedule of its intrastate access charge rate reductions and corresponding AUSF support based on 2009 (base year) data. Prior to December 1, 2010, the Commission shall approve or deny each carrier's proposed reductions and AUSF support amounts.
- D. After receipt of Commission approval, the administrator shall calculate the monthly amount of AUSF support for each carrier and begin distribution of AUSF support provided for under this section. Monthly disbursements shall commence January 2011. Monthly disbursements under this section for each carrier shall remain fixed until an order mandating the revision of AUSF support is received under this section. Notwithstanding, no revisions to AUSF support received under this section shall occur until January 1, 2014.
- E. On or after January 1, 2014, the Commission, on its own motion or on the motion of a party or the administrator, may order the revision of a local exchange carrier's intrastate access charge rate reduction schedule and corresponding AUSF support received under this section.
- F. The Commission may, upon motion of a carrier or the administrator, or upon the Commission's own motion, authorize further intrastate switched access charge reductions for a carrier to correspond to any changes in Qwest's intrastate switched access service charge rates, elements or structure subsequent to January 1, 2011. Such changes to rates, elements or structure would continue to use 2009 (base year) minutes-of-use of each carrier in calculating the amount of AUSF support provided for under this section.

R14-2-1202(B)
Facility Extension Requests

- A. Applications for Distribution:

- (1) Potential customers not presently receiving basic local service because facilities are not available many apply to the Commission for distribution from the fund for extension of service to themselves or to a group of customers.
- (2) Those distributions are to be approved by the Commission, and made only in circumstances where traditional methods of funding and service provision are infeasible.
- (3) Distributions will not be made for customers who are not full time residents.
- (4) An application for a distribution may be filed with the Commission by an individual or group of consumers desiring telephone service, a telecommunications corporation on behalf of those consumers, the Commission staff, or any entity permitted by law to request agency action. An application shall identify the service(s) requested, the area to be served and the individuals or entities that will be served if the distribution is approved.
- (5) Following the application's filing, the affected telecommunications corporations shall provide any pertinent information requested by the Commission Staff including engineering, facilities and cost information that will assist in the Commission's consideration of the application.
- (6) In considering the application, the Commission will examine relevant facts including the type and grade of service to be provided, the cost of providing the service, the demonstrated need for the service, whether the customer is within the service territory of a telecommunications corporation, whether the proposed service is for a primary full time residence and other relevant factors to determine whether the one-time distribution is in the public interest.

B. Presumed reasonable amounts and terms:

- (1) Unless otherwise ordered by the Commission, the maximum distribution will be no more than \$25,000 per customer. The Commission will presume a wireline company's service or line extension terms and conditions reasonable for a subscriber connection with universal service fund distribution requests, if the costs of service extension are recovered as follows:
 - a. The first \$500 of cost coverage is provided by the company, and
 - b. For cost amounts exceeding the \$500 level, up to two times the statewide average loop investment for all regulated companies as determined annually by the Commission, equally provided by the company and the customer.
- (2) When the Commission approves an application for the use of AUSF: 95 percent of service extension costs above those recovered through the service extension cost recover terms specified above, shall be paid through AUSF, up to the maximum universal service fund expenditure levels specified by this rule. The remaining five percent or any additional amounts shall be paid by additional customer contributions beyond those specified above.

- (3) Potential customers in the area shall be notified by the telecommunications corporation of the nature and extent of the proposed service extension, the Commission's approval of the application, and the necessary customer contribution amounts to participate in the project. Customer contribution payments shall be made prior to the start of construction.
- (4) Within five years following approval of the application, any customer that seeks telecommunications service in the project area serviceable by an AUSF-funded loop drop shall pay a customer contribution equal to the original customer contributions in the project. Funds received through these payments shall be sent to the AUSF administrator.
- (5) For each customer added during the five-year period following project completion, the telecommunications corporation and new customers shall bear the costs to extend service pursuant to the company's service or line extension terms and conditions and up to the telecommunications corporation's original contribution per customer for the project and the customer contribution required by this rule. The company may petition the Commission for a determination of the recovery from universal service fund and the new customer for costs which exceed this amount.
- (6) Impact of distribution on Companies – A distribution from the fund under this subsection shall be recorded on the books of a regulated LEC as an aid to construction and treated as an offset in rate base.
- (7) Notice and Hearing – Following notice that a distribution application has been filed any interested party may request a hearing or seek to intervene to protect its interest.
- (8) Bidding for Unserved Areas – If only one telecommunications corporation is involved in the distribution request, the distribution will be provided based upon the actual costs of that company. If additional telecommunications corporations are involved, the distribution will be determined on the basis of a competitive bid. The estimated amount of the distribution will be considered in evaluating each bid. Fund distributions in that area will be based on the winning bid.

R-14-2-1203
Request for AUSF Support

A provider of basic local exchange telephone service may request that the Commission authorize AUSF support with a filing under R14-2-103, R14-2-1202(A), R14-2-1202(B), or other method as the Commission may prescribe, and upon compliance with all applicable rules set forth in R14-2-1101 through R14-2-1115. A request for AUSF support shall include a statement describing the need for such funding. The Commission shall determine the appropriate cost of providing basic local exchange service for each AUSF support area for which AUSF support is requested and shall calculate in accordance with R14-2-1202 the amount of AUSF support, if any, to which the applicant is entitled. A provider of basic local exchange telephone service may request that the Commission authorize Revenue Neutral AUSF support, after fulfilling the requirements in Section R14-2-1202(A).

Historical Note

~~Adopted effective April 26, 1996, under an exemption as determined by the Arizona Corporation Commission (Supp. 96-2).~~

R14-2-1204
Funding of the AUSF

A. The AUSF shall be funded in accordance with this Article by all telecommunications service providers that interconnect to the public switched network. Within 30 days of the effective date of this Article, and thereafter on or before October 1 of each year, each telecommunications provider shall provide to the Administrator a list of all other telecommunications providers that interconnect to its facilities or network.

B. The AUSF shall be funded equally by toll and local customers of the providers of telecommunications services, and shall be assessed in the following manner:

1. ~~Category 1 — Providers of basic local exchange service, as discussed in R14-2-1204(B)(1)(a), and other service providers as required under R14-2-1204(B)(1)(a)(i) or permitted under R14-2-1204(B)(3)(b), shall be considered providers of category 1 service.~~

a. ~~One half of the AUSF funding requirement will be collected through Category 1 service providers. Category 1 AUSF assessment will be based upon access lines and interconnecting trunks, and assessed by providers of local switched access as either an access line or interconnecting trunk surcharge. The "per access line" surcharge to be in place during a given year will be calculated by the Administrator using the total number of access lines and equivalent access lines deriving from interconnecting trunks that were in service for all Category 1 service providers on October 1 of the previous year. Access lines shall include business and residence lines, public access lines, and other identifiable access lines. All wireless providers including but not limited to paging and other Commercial Mobile Radio Service providers, that interconnect to the public switched network will contribute to the AUSF under the requirements of Category 1. The number of interconnecting trunks obtained from the local access provider by the wireless provider shall be utilized in conjunction with a Conversion Factor to determine AUSF support from such wireless provider by means of a surcharge on such interconnecting trunks. A wireless provider that fails to contribute to the AUSF as required by this Article shall be subject to termination of its interconnection arrangements pursuant to R14-2-1214(C).~~

b. ~~On or before November 1 of each year, each Category 1 local switched access service provider shall provide to the Administrator the number of access lines and number of interconnecting trunks that were in service on October 1 of that year. The Administrator will use these numbers together with the Conversion Factor in calculating the per access line surcharge and per interconnecting trunk surcharge for the following year. The Administrator will multiply the total number of interconnecting trunks by the Conversion Factor to obtain an equivalent number of access lines for the purpose of calculating the surcharges.~~

2. ~~Category 2 — Providers of Intrastate toll service or other service providers as permitted under R14-2-1204(B)(3), shall be considered providers of Category 2 service and shall be assessed AUSF charges as follows:~~

a. ~~One half of the AUSF funding requirement will be collected through Category 2 service providers. The Category 2 AUSF assessment will be based on total Arizona intrastate toll revenue, and assessed as a percent of revenue. The percent of revenue assessment to be in place during a given year will be calculated by the Administrator using the annual Arizona intrastate revenue for all Category 2 service providers for the previous year.~~

- b. ~~On or before November 1 of each year, each Category 2 service provider shall report to the Administrator the total Arizona intrastate revenue collected between August 1 of the current year and Aug 1 of the previous year. The administrator will use this revenue so reported to calculate this AUSF assessment rate for the following year.~~
- 3. ~~New telecommunications service providers.~~
 - a. ~~Telecommunications providers that begin providing basic local exchange service after the effective date of this Article shall be assessed AUSF charges pursuant to R14-2-1204(B)(1). Telecommunications providers that begin providing toll service after the effective date of this Article shall be assessed AUSF charges pursuant to R14-2-1204(B)(2).~~
 - b. ~~All other telecommunications service providers that interconnect to the public switched network and begin providing telecommunications service after the effective date of this Article, shall choose to be considered either a Category 1, Category 2, or both Category 1 and Category 2 service provider. Such election shall be made in writing to the Administrator within 30 days of beginning to provide telecommunications service in Arizona, with a copy to the Director of Utilities. Written concurrence of the Director of Utilities must be received by the Administrator for such selection to be effective. Such selection will be irrevocable for a period of at least three years.~~
- 4. ~~A telecommunications provider that provides both Category 1 and Category 2 services shall be assessed AUSF charges pursuant to both R14-2-1204(B)(1) and R14-2-1204(B)(2).~~

Historical Note

Adopted effective April 26, 1996, under an exemption as determined by the Arizona Corporation Commission (Supp. 96-2).

R14-2-1205
Calculation of Surcharges

- A. ~~The Administrator will calculate the total AUSE support due all local exchange carriers who have been granted AUSE support by the Commission. Administrative costs and audit fees will be added to this amount. The amount of any excess funds in the AUSE will then be subtracted to determine the total funding requirement. The funding requirements from Category 1 and Category 2 service providers will then be calculated. One half of the funding will be obtained from Category 1 providers through surcharges applied to access lines and interconnecting trunks in service. The other half will be obtained from Category 2 providers through surcharges on intrastate toll revenues.~~
- B. ~~For the purpose of determining the surcharges, the Administrator will develop growth factors to apply to the total reported access lines and toll revenues. Such growth factors will be calculated at 1/2 of the estimated annual percentage growth in access lines and in toll revenues.~~
- C. ~~Category 1 Surcharge. One half of the total annual AUSE support approved by the Commission for all eligible recipients will be obtained from Category 1 service providers. A monthly per access line surcharge and a monthly per interconnecting trunk surcharge required to obtain this funding will be calculated as follows:~~
- ~~1. Adding together the number of access lines and equivalent access lines for all Category 1 service providers, adjusted by the growth factor;~~
 - ~~2. Dividing the total annual AUSE support approved by the Commission for all eligible recipients by 2 to obtain the portion of AUSE required from Category 1 service providers;~~
 - ~~3. Dividing the amount of Category 1 AUSE support calculated in subsection (C)(2) by the sum of access lines calculated in subsection (C)(1) to yield the per access line surcharge;~~
 - ~~4. Dividing the per access line surcharge calculated in subsection (C)(3) by 12 to determine the monthly access line assessment;~~
 - ~~5. Multiplying the surcharge obtained in subsection (C)(4) by the Conversion Factor to determine the monthly interconnecting trunk surcharge.~~
- D. ~~Category 2 Surcharge. One half of the total annual AUSE support approved by the Commission for all eligible recipients will be obtained from Category 2 service providers. A percent of revenue surcharge required to obtain this funding will be calculated as follows:~~
- ~~1. Totalling the annual intrastate toll revenues of all Category 2 service providers, adjusted by the growth factor;~~
 - ~~2. Dividing the total AUSE support approved by the Commission for all eligible recipients by 2 to obtain the portion of AUSE support required from Category 2 service providers;~~
 - ~~3. Dividing the amount of Category 2 AUSE support requirement calculated in subsection (D)(2) by the total annual intrastate toll revenues calculated in subsection (D)(1) to arrive at a percentage of revenue surcharge.~~
- E. ~~Recipients of lifeline or other low income support shall be exempt from paying a Category 1 surcharge.~~

Historical Note

Adopted effective April 26, 1986, under an exemption as determined by the Arizona Corporation Commission (Supp. 96-2).

R14-2-1205
Determination of AUSF Surcharge Rate and Contribution

- A. The administrator, or the Commission, shall determine the state USF surcharge rate annually, on or before November 1 of each year, in sufficient time for contributions to be paid into and disbursements to be made from the fund. The surcharge rate will be based upon monthly and annual reports filed by ETCs, local exchange carriers eligible for revenue-neutral AUSF support pursuant to R14-2-1202(A), and contributing companies, and any other pertinent and reliable information available to the administrator or the Commission.
- B. Upon its determination of a USF surcharge rate, the administrator shall notify all contributing companies, ETCs, and the Commission. The rate determined by the administrator shall go into effect unless modified or disapproved by the Commission.
- C. The surcharge rate shall be equal to the annual fund requirement divided by the sum of intrastate retail telecommunications revenue for all contributing carriers in Arizona, and may be adjusted to account for any material deficit or surplus projected to exist at the start of the fund year.
- D. Each contributing company's monthly contribution shall equal the state USF surcharge rate multiplied by its intrastate retail telecommunications revenues in Arizona for the month.
- E. If, for any month the administrator finds that the fund balance is insufficient to cover required disbursements plus administrative expenses including audit fees, the administrator may, with the Commission's approval, increase contribution requirements to make up the shortfall. If the fund accumulates a surplus beyond what the administrator and the Commission believe is prudent under the circumstances, the administrator may, with the Commission's approval, decrease contribution requirements so as to lower the fund balance to an appropriate level.
- F. Each contributing company shall remit its monthly contribution to the administrator on a schedule to be determined by the administrator

R14-2-1206
Implementation

- A. ~~A.—Any provider of telecommunications service may file either an AUSF tariff or price list, if appropriate, establishing a flow-through mechanism to collect the surcharge approved by the Commission and calculated by the Administrator.~~
- B. ~~B.—On or before the 20th day of each month, each Category 4telecommunication service provider responsible for collecting AUSF surcharges shall remit to the Administrator the AUSF surcharge, including any surcharge on wireless providers, collected by that telecommunications service provider during the preceding month. The Category 4 telecommunications service provider shall submit such documentation of AUSF revenues from the AUSF surcharge as may be required by the Administrator.~~
- C. ~~On or before the 20th day of each month, each Category 2 service provider responsible for collecting AUSF surcharges shall remit to the Administrator the AUSF surcharge~~

collected by that provider during the third preceding month. The Category 2 provider shall submit such documentation of AUSF revenues from the AUSF surcharge as may be required by the Administrator.

C. ~~D.~~ Eligible recipients of AUSF support are:

(1) Providers of telecommunications service engaged in providing basic local exchange telephone service in Arizona which have obtained a Commission order authorizing payments from the AUSF; and

(2) Local exchange carriers eligible for revenue-neutral support based upon the provisions of R14-2-1202(A); and

~~(2)~~(3) Providers that become entitled to AUSF support based upon the provisions of R14-2-1206(E).

D. ~~E.~~ If the Commission approves AUSF support to a provider of telecommunications service for a defined area, such AUSF support shall also be available to competitive providers of basic local exchange service in the same defined area that are contributing to the AUSF, and that are willing to provide service to all customers in the specific AUSF support area as defined by the Commission. The AUSF support to which the competitive provider is eligible shall be calculated based on the competitive carriers cost on a per-customer basis, ~~at the same level at which the incumbent provider of telecommunications service receives AUSF support, and but~~ shall not result in an increase in the total cost based AUSF support available for the specific census block groups or study area. If basic exchange service is provided through the resale of another carrier's local loop facilities, AUSF based support will only be available to the retail service provider if AUSF support is not included in the wholesale price for the resold local service. This Section shall not apply to small local exchange carriers ~~nor~~ to the universal service support being received by any telecommunications service provider as of the effective date of this Article.

E. ~~F.~~ For small local exchange carriers and for any basic local exchange telephone service provider receiving universal service support as of the effective date of this Article, the AUSF cost based support shall not be available to competitive providers of basic local exchange service prior to completion of the review provided for in R14-2-1216. Following completion of the review, AUSF cost based support provided to small ~~and intermediate~~ local exchange carriers shall be available to all competitive ~~providers of eligible telecommunications carriers providing~~ basic local exchange service in the defined area ~~that are~~ and contributing to AUSF, and that are willing to provide service to all customers in the specific geographic study area as defined by the Commission, unless otherwise ordered by the Commission.

F. ~~G.~~ Defined area, study area, geographic area, and support area mean the same area during the first three years of the effective date of this Article. After the first three years, they will still have the same meaning unless otherwise ordered by the Commission.

Historical Note

Adopted effective April 26, 1996, under an exemption as determined by the Arizona Corporation Commission (Supp. 96-2).

R14-2-1207

Calculation of Monthly Payments and the Associated Collections

- ~~A. For the monthly Category 1 AUSF payment, each provider of local switched access shall remit to the Administrator an amount equal to the number of access lines in service on the first day of the month, times the monthly surcharge per access line plus the number of interconnecting trunks in service on the first day of the month, times the monthly interconnecting trunk surcharge.~~
- A. B.—The monthly AUSF payment that each ~~Category 2~~Telecommunications Service Provider shall remit to the Administrator is an amount equal to its total monthly intrastate toll-revenue times the monthly surcharge percentage.
- B. C.—Payments must be received by the Administrator by the 20th day of each month. If the payment amount is greater than \$10,000, then it shall be wire transferred to the Administrator.
- C. D.—The Administrator shall enter into an appropriate non-disclosure agreement with each telecommunications service provider to assure that information necessary to allocate AUSF funding obligations and to calculate surcharges is reported, maintained, and used in a manner that will protect the confidentiality of company specific data. The Administrator shall not use confidential data for any purpose other than administering the AUSF.

Historical Note

~~Adopted effective April 26, 1996, under an exemption as determined by the Arizona Corporation Commission (Supp. 96-2).~~

R14-2-1208
Monthly AUSF Disbursements

- | A. A.—AUSF disbursement shall be made 30 days following the date of AUSF collections.
- | B. B.—The Administrator shall not make AUSF support payments to a provider of telecommunications service until the Administrator has received a copy of a Commission decision authorizing the provider to receive such support.

Historical Note

~~Adopted effective April 26, 1996, under an exemption as determined by the Arizona Corporation Commission (Supp. 96-2).~~

R14-2-1209

Procedures for Handling AUSF Rate Changes

- | A. ~~A. Category 1 and Category 2~~ AUSF surcharges shall be revised when the Commission authorizes new or revised AUSF payments to any provider of telecommunications service. The Administrator shall calculate the new AUSF flow-through surcharges in accordance with this Article, which surcharge shall become effective upon the Commission's approval of the new or revised AUSF payments.
- | B. ~~B.~~ An annual calculation to revise AUSF flow-through surcharges shall be made by the Administrator on December 1 of each year with an effective date the following January 1. The flow-through surcharges shall be calculated so that the total AUSF funding will equal the AUSF revenue requirements plus administrative costs including audit fees as well as any corrections and true-ups. No later than December 1 of each year, the Administrator shall provide notice to the Commission and all telecommunication service providers who pay into the AUSF of the flow-through surcharge rates for the following calendar year.

Historical Note

~~Adopted effective April 26, 1996, under an exemption as determined by the Arizona Corporation Commission (Supp. 96-2).~~

R14-2-1210
Statement of Participation of All Telecommunications
Service Providers in the AUSF

- | A. A.—Within 30 days of the effective date of this Article, each telecommunications service provider shall provide a letter to the Administrator acknowledging that provider's obligation under this Article to pay AUSF surcharges. Failure to provide such a letter shall be grounds for termination after written notice from the Administrator of the provider's interconnection with the public switched network.
- | B. B.—Any telecommunications service provider which begins providing telecommunications service after the effective date of this Article shall, within 30 days of beginning to provide intrastate service in Arizona, provide a letter to the Administrator acknowledging that provider's obligation under this Article to make monthly payments for the local and/or toll portion, as appropriate, of the AUSF contribution in accordance with this Article. Failure to provide such a letter shall be grounds for denying to the provider interconnection with the public switched network.

Historical Note

~~Adopted effective April 26, 1996, under an exemption as determined by the Arizona Corporation Commission (Supp. 96-2).~~

R14-2-1211
Duties and Responsibilities of the AUSF Administrator

The Administrator shall:

- (1) Develop, obtain, and, on or before December 15 of each year, file with the Commission such information and documentation as the Administrator deems necessary for the establishment and calculation of the ~~Category 1 and Category 2~~ surcharges for the succeeding year. Such a filing shall also be made each time the Commission authorizes a change in the AUSF funding requirement.
- (2) Monitor the AUSF payments of all telecommunications providers.
- (3) Oversee the billing of AUSF surcharges.
- (4) Prepare the necessary forms to be used in reporting the AUSF collections and disbursements and maintain monthly records.
- (5) Coordinate the collection and disbursement of AUSF monies in accordance with this Article.
- (6) Prepare an annual report that provides a detailed accounting of the AUSF collections and disbursements and that identifies the annual cost of administration. The report shall be filed with the Commission on or before April 15 of each year.
- (7) Monitor procedures for auditing the AUSF collections and disbursements. The audit function shall be performed by an independent outside auditor.

Historical Note

~~Adopted effective April 26, 1996, under an exemption as determined by the Arizona Corporation Commission (Supp. 96-2).~~

R14-2-1212
Interim Administrator

US WEST Communications, Inc., will serve as interim Administrator of the AUSE and will perform the functions detailed herein that are required of the Administrator for a transition period until a private, neutral third party is appointed by the Commission to serve as Administrator of the AUSE. A neutral third party selected through the competitive bid process shall be appointed no later than July 1, 1997.

Historical Note

Adopted effective April 26, 1996, under an exemption as determined by the Arizona Corporation Commission (Supp. 96-2).

(8) Oversee reimbursement of the responsible agency's costs of administering Lifeline and Link-Up programs of Eligible Telecommunications Carriers pursuant to Article 22.

R14-2-1213
Guidelines for Auditing the AUSF

- | A. A.—The AUSF records covering both collections and disbursements shall be audited at the end of the first year following the designation of a third party administrator. The AUSF records will then be audited at least once every other year in the subsequent years of operations.
- | B. B.—The records shall be examined for accuracy and the existence of effective internal controls to ensure that the AUSF is being administered appropriately and properly.
- | C. C.—An independent external auditor selected by the Commission shall be utilized to provide an unbiased audit opinion concerning the AUSF administration procedures and controls.
- | D. D.—Any costs for conducting audits will be deducted from the revenues of the AUSF prior to disbursement of funds.

Historical Note

~~Adopted effective April 26, 1996, under an exemption as determined by the Arizona Corporation Commission (Supp. 96-2).~~

R14-2-1214

Enforcement of Collection of Delinquent AUSF Amounts

- | A. A.—The Administrator shall issue past due notices to each provider of telecommunications service that is 15 days or more delinquent in submitting its AUSF payments to the Administrator. A copy of this notice shall be provided to the Commission.
- | B. B.—AUSF support payments shall be withheld from any provider of telecommunications service that is delinquent in submitting its AUSF payments to the Administrator. Each provider of telecommunications service will be fully liable for any accrued interest owing on its AUSF contributions that remain unpaid for 30 days. Such delinquent AUSF payments will begin accruing interest at the rate of 1 and ½% per month beginning with the 31st day until such amount is paid in full along with all accrued interest.
- | ~~C. The local switched access service provider shall promptly notify the Commission and the Administrator of the identity of any wireless provider which fails or refuses to pay its AUSF surcharge. Such notice shall also be directed to the wireless provider. If the wireless provider has not paid the amount due within 30 days of such notice, the interconnection provider shall terminate the wireless provider's interconnection until the full amount together with all accrued interest, is paid in full (unless the payment is in bonafide dispute and the wireless carrier has paid the undisputed amount).~~
- | C. D.—Failure by the Telecommunications service provider to comply with the provisions of this Article any result in sanctions as determined by the Commission.

Historical Note

Adopted effective April 26, 1996, under an exemption as determined by the Arizona Corporation Commission (Supp. 96-2).

**R14-2-1215
AUSF Annual Report**

A. A.—On or before April 1 of each year, the Administrator shall file with the Commission an annual report which shall summarize the preceding year activity and contain the following:

- (1) A statement of AUSF collections and disbursements.
- (2) A record of the total cost of administration of the AUSF.
- (3) Audit reports from the audits conducted during the year.

B. B.—A copy of the annual report shall be provided to each provider of telecommunications service who contributes to the AUSF.

Historical Note

~~Adopted effective April 26, 1996, under an exemption as determined by the Arizona Corporation Commission (Supp. 96-2).~~

F14-2-1216
Review Process

- A. ~~A. Not later than~~ Three years from the effective date of this Article, the Commission staff ~~shall initiate~~ may consider the necessity of a comprehensive review of this Article. Upon recommendation from the Commission, the Commission staff shall initiate such review of this Article and shall provide the Commission with recommendations regarding any necessary changes to the Article. ~~Any interested party may also make such recommendations.~~ The Commission shall consider these recommendations in such proceeding as the Commission deems appropriate.
- B. ~~B.~~ The costs used to calculate AUSF funding levels for a given provider or AUSF support area ~~shall~~ may be reviewed by the Commission at least every three years following the effective date for any authorized AUSF support for the provider or study area. The Commission may reduce the authorized funding level and require that the AUSF surcharge be recalculated on the basis of this review.

Historical Note

~~Adopted effective April 26, 1996, under an exemption as determined by the Arizona Corporation Commission (Supp. 96-2).~~

F14-2-1217
Supersession of Existing USF Mechanism

The universal service funding mechanism initially approved by the Commission in Decision No. 56639 (September 22, 1989) is superseded by this Article, except that any calculation, contribution or collection of, or entitlement to, universal service fund support approved by the Commission prior to the adoption of this Article shall remain in effect until otherwise ordered by the Commission or until the Application of this Article leads to a different result.

Historical Note

~~Adopted effective April 26, 1996, under an exemption as determined by the Arizona Corporation Commission (Supp. 96-2).~~

~~Editor's Note: The Arizona Corporation Commission has determined that the following Article is exempt from the Attorney General approval provisions of the Arizona Administrative Procedure Act (A.R.S. § 41-1041) by a court order (State ex. rel. Corbin v. Arizona Corporation Commission, 174 Ariz. 216 848 P.2d 301 (App. 1992)).~~

Direct Testimony of Douglas Duncan Meredith
Arizona Corporation Commission
December 1, 2009
Exhibit DDM-03

ARTICLE 22. LIFELINE AND LINKUP BENEFITS

R14-2-2201. Application

This rule applies to all entities that have been designated by the commission as eligible telecommunications carriers and that may receive disbursements from the state universal service fund or the federal universal service fund.

R14-2-2202. Definitions

For purposes of this Article, the following definitions apply unless the context otherwise requires:

1. "applicant" means an eligible customer of an eligible telecommunications carrier;
2. "carrier" means an entity that provides intrastate retail public telecommunications services or comparable retail alternative services in Arizona;
3. "eligible telecommunications carrier (ETC)" means a carrier that has been designated by the commission as eligible to receive disbursements from the state universal service fund or the federal universal service fund;
4. "federal poverty guidelines" means the poverty guidelines issued each year by the federal health and human services department and published in the federal register;
5. "income" means all income actually received by all members of the household. This includes salary before deductions of taxes, public assistance benefits, inheritances, alimony, child support payments, workers' compensation benefits, gifts, lottery winnings, and the like. The only exceptions are student financial aid, military housing and cost-of-living allowances, irregular income from occasional small jobs such as baby-sitting or lawn mowing, and the like;
6. "responsible agency" means the state government agency or other entity designated by the commission to administer the certification, verification and continued verifications of lifeline enrollment.

R14-2-2203. Eligibility Requirements

A. Program-Based Criteria: all ETCs shall provide lifeline and linkup benefits to any applicant who self-certifies, under penalty of perjury, that his or her household is eligible for public assistance under one or more of the following programs:

1. Temporary Assistance to Needy Families (TANF);
2. Food Stamps;
3. Low Income Home Energy Assistance Program (LIHEAP);
4. Medicaid, including KidsCare;
5. Supplemental Security Income;
6. National School Lunch Program; or
7. Federal Public Housing Assistance.

B. Income-Based Criteria: all ETCs shall provide lifeline and linkup benefits to any applicant who certifies, with supporting documentation and under penalty of perjury, that his or her household income is at or below 150 percent of the applicable federal poverty guidelines upon annual publication by the U. S. Department of Health and Human Services in the Federal Register.

1. income-based eligibility is based, in part, on household size. Therefore, an applicant must certify, under penalty of perjury, the number of individuals residing in his or her household.
2. an applicant must certify, under penalty of perjury, that the documentation supporting income-based certification accurately represents the applicant's annual household income. The following documents, or any combination of these documents, are acceptable to support certification based upon income:

- a. prior year's state, federal or Tribal tax returns;
- b. current year-to-date earnings statement from an employer or three consecutive months of paycheck stubs;
- c. Social Security Administration statement of benefits;
- d. Veteran's Administration statement of benefits;
- e. Retirement/pension statement of benefits;
- f. Unemployment/Workers Compensation statement of benefits;
- g. Federal or Tribal notice of participation in Bureau of Indian Affairs General Assistance; or
- h. Divorce decree or child support wage assignment statement.

C. Application: The application form for participation in lifeline and linkup benefits shall be available from each ETC, the commission's consumer services division, and the responsible agency, if one has been designated by the commission. Each completed application shall contain the following information, where applicable:

- 1. applicant's name, telephone number and home address;
- 2. the particular public assistance program(s), if applicable, and identification of the ETC that the applicant anticipates will provide service;
- 3. an affirmative statement that the applicant qualifies for lifeline or linkup benefits;
- 4. an affirmative statement under penalty of perjury affirming that the applicant is participating in one of the programs listed in R14-2-2203(A), or a statement under penalty of perjury affirming that the applicant's household income is at or below 150 percent of the federal poverty guidelines;
 - a. if the application is based on income criteria, a statement under penalty of perjury that identifies the number of individuals residing in the household and affirms that the documentation presented to support income-based eligibility accurately represents the applicant's household income;
- 5. an affirmative statement under penalty of perjury that the applicant is not receiving lifeline benefits of any kind on any other telephone or wireless account; and
- 6. the applicant's signature.

D. Document retention: the ETC and/or responsible agency shall retain eligibility applications for three [3] calendar years.

E. Tribal land lifeline and linkup benefits: customers who live on Tribal lands and who qualify for state lifeline and linkup benefits based on the program or income criteria set forth in R-14-2-2203(A) and (B) are eligible to receive prescribed federal benefits. Such federal benefits are not within the scope of, nor governed by, this rule.

R14-2-2204. Continuing Eligibility

A. Annual Verification: the continuing eligibility of customers for lifeline benefits shall be verified annually.

B. Verification Methods: the ETC and/or responsible agency shall verify the continued eligibility of lifeline customers under the program-based and income-based eligibility criteria.

- 1. the ETC and/or responsible agency shall establish methods by which program-based and income-based eligibility shall be verified on an annual basis including, but not limited to, self-certification, reviews of state computer data bases, beneficiary audits, income documentation, or the continued eligibility of a statistically valid sample of lifeline customers.

C. Termination Notices and Dispute Resolution: if a customer fails to establish continued eligibility, the ETC and/or responsible agency shall notify the customer of its intent to discontinue the customer's eligibility and the basis for that decision.

1. the eligibility termination notice shall be in writing and shall be delivered to the customer's mailing address.
2. the eligibility termination notice must allow the customer at least 60 days to demonstrate the continued eligibility consistent with this rule. The customer's participation in lifeline service may not be discontinued during this 60-day period.
3. the eligibility termination notice shall include a statement advising the customer of the option to continue local telephone service after termination of lifeline service benefits at the non-discounted rate.
4. if the customer fails to provide proof of continued eligibility as required, or the ETC and/or responsible agency does not accept the customer's proof of continued eligibility, the ETC and/or responsible agency shall notify the customer in writing of its determination to discontinue the customer's participation in lifeline benefits.. The notice shall include instructions for filing an appeal of the determination.
5. if the customer disputes the non-eligibility determination, he or she shall notify the ETC or responsible agency. If the customer is still unable to resolve the dispute, he or she may appeal a non-eligibility determination within 60 days of the date of the notice from the ETC and/or responsible agency by filing a written notice of appeal with the commission. Lifeline benefits will continue pending an appeal of a non-eligibility determination.

R-14-2-2205. Lifeline And Linkup Benefits

A. Benefits: lifeline benefits provided by ETCs shall consist of basic service, or its functional equivalent and any other lifeline benefits established by the federal communications commission. ETCs shall provide linkup benefits in accordance with the federal linkup program utilizing the eligibility criteria set forth in R14-2-2103(A) and (B).

B. Deposits: when customer security deposits are otherwise required, they will be waived for lifeline service customers if the customer voluntarily elects to receive toll blocking.

C. Nonrecurring Charge Waiver: lifeline customers will receive a waiver of the nonrecurring charge for changing the type of local exchange usage service to lifeline, or changing from flat rate service to message rate service, or vice versa, but only one such waiver shall be allowed during any 12-month period.

D. Termination: lifeline benefits shall not be terminated for nonpayment of toll service.

E. Restrictions: a lifeline customer may receive lifeline and linkup benefits only for the customer's principal service line.

F. Other Services: a lifeline customer will not be required to purchase other services from the ETC, nor prohibited from purchasing other services, unless the customer has failed to comply with the ETC's terms and conditions for those services.

R-14-2-2206. Cost Recovery

The total cost of providing lifeline service, including the administrative costs of the ETCs and the costs incurred by the responsible agency, shall be recovered and funded from the state rural universal service fund pursuant to Article 12.

BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS

KRISTIN K. MAYES, Chairman
GARY PIERCE
PAUL NEWMAN
SANDRA D. KENNEDY
BOB STUMP

IN THE MATTER OF THE REVIEW AND
POSSIBLE REVISION OF ARIZONA
UNIVERSAL SERVICE FUND RULES,
ARTICLE 12 OF THE ARIZONA
ADMINISTRATIVE CODE.

DOCKET NO. RT-00000H-97-0137

IN THE MATTER OF THE INVESTIGATION OF
THE COST OF TELECOMMUNICATIONS
ACCESS.

DOCKET NO. T-00000D-00-0672

**NOTICE OF FILING
REPLY TESTIMONY OF DOUGLAS DUNCAN MEREDITH**

The Arizona Local Exchange Carriers Association ("ALECA") hereby files the Reply
Testimony of Douglas Duncan Meredith.

RESPECTFULLY SUBMITTED on February 5, 2010.

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BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS

KRISTIN K. MAYES, Chairman
GARY PIERCE
PAUL NEWMAN
SANDRA D. KENNEDY
BOB STUMP

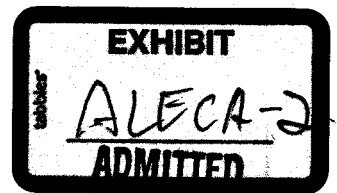
IN THE MATTER OF THE REVIEW AND
POSSIBLE REVISION OF ARIZONA
UNIVERSAL SERVICE FUND RULES,
ARTICLE 12 OF THE ARIZONA
ADMINISTRATIVE CODE.

DOCKET NO. RT-00000H-97-0137

IN THE MATTER OF THE INVESTIGATION OF
THE COST OF TELECOMMUNICATIONS
ACCESS.

DOCKET NO. T-00000D-00-0672

**REPLY TESTIMONY OF
DOUGLAS DUNCAN MEREDITH
ON BEHALF OF
THE ARIZONA LOCAL EXCHANGE
CARRIERS ASSOCIATION**



I INTRODUCTION

**Q: ARE YOU THE SAME DOUGLAS DUNCAN MEREDITH WHO SUBMITTED
DIRECT TESTIMONY IN THESE DOCKETS ON DECEMBER 1, 2009.**

A: Yes.

Q: WHAT IS THE PURPOSE OF YOUR REPLY TESTIMONY?

A: I first provide specific answers to the 12 questions in Judge Rodda's September 29, 2009, Procedural Order. I then respond to the testimonies of Staff witness Wilfred Shand, Qwest witness Peter Copeland, Verizon witness Don Price, RUCO witness Ben Johnson, and AT&T witnesses Debra Aron and Ola Oyefusi.¹ There are certain areas of these testimonies that are either inaccurate or that could lead the Commission to draw an erroneous conclusion in its determination in this proceeding.

II PROCEDURAL ORDER ISSUES

**Q. IN YOUR DIRECT TESTIMONY DID YOU SPECIFICALLY ADDRESS THE
TWELVE ISSUES IDENTIFIED BY JUDGE RODDA IN HER SEPTEMBER 29,
2009 PROCEDURAL ORDER?**

A. No. I believe my Direct Testimony covered all these issues, but so that ALECA's position is clear, I have attached Exhibit DDM-R1, which specifically answers each of the 12 questions in the Procedural Order.

III REPLY TO STAFF

¹ In the Matter of the Review and Possible Revision of Arizona Universal Service Fund Rules, Article 12 of the Arizona Administrative Code, Docket No. RT-00000H-97-0137; In the Matter of the Investigation of the Cost of Telecommunications Access, Docket No. RT-00000D-00-0672, Direct Testimony of Wilfred Shand, Jan 8, 2010 ("Shand Direct"); Direct Testimony of Peter B. Copeland, Dec 1, 2009 ("Copeland Direct"); Direct Testimony of Don Price, Dec. 1, 2009 ("Price Direct"); Direct Testimony of Ben Johnson, Ph.D., January 6, 2010 ("Johnson Direct"); Direct Testimony of Dr. Debra J. Aaron, Dec. 1, 2009 ("Aron Direct") and Direct Testimony of Dr. Ola Oyefusi, Dec. 1, 2009 ("Oyefusi Direct").

1 Q: WHAT IS THE FIRST ISSUE YOU HAVE WITH MR. SHAND'S TESTIMONY
2 ON BEHALF OF THE COMMISSION STAFF?

3 A: First, Mr. Shand recommends that a revenue-neutral shift of intrastate-access revenues
4 should trigger a rate case for each ALECA member unless the ALECA member absorbs
5 the access-charge reductions.² Mr. Shand suggests "Staff has no bona fide recent sense
6 of the financial condition of the other ALECA companies other than their assertion that
7 they need AUSF in order to survive the decline in access revenues."³ However the
8 ALECA members are regulated by this Commission and consequently the intrastate rates
9 of the ALECA members are presumed to be reasonable. Staff's recommendation would
10 turn this presumption on its head and effectively require that ALECA members prove that
11 existing intrastate rates are reasonable before they could receive rate relief to offset
12 access-charge reduction.

13 I do agree in a theoretical sense with Mr. Shand's statement that a "change to other rates
14 of the company could be made to offset the switched access charge reduction as long as
15 the change in rates was overall revenue neutral outside of a rate case."⁴ Of course, this
16 same reasoning supports receiving AUSF support in a revenue-neutral manner to offset
17 access-charge reductions. To state that other rate changes could offset access-charge
18 reductions, while not agreeing that AUSF support could serve the same purpose, seems to
19 be making a distinction without a difference. Adopting the ALECA proposal for
20 intrastate access reform outside of a rate case is allowed by the *Scates* doctrine,⁵ and the
21 Commission's AUSF rules. Specifically, the "AUSF rules permit the Commission to

² Shand Direct at Executive Summary 1-2.

³ *Id.* at 19:16-18.

⁴ *Id.* at Response to Issue 7 posed by the Administrative Law Judge, October 1, 2009, ("Procedural Order").
(Emphasis supplied.)

⁵ *Scates v. Arizona Corp. Comm'n*, 118 Ariz. 531, 578 P.2d 612 (App. 1978).

1 authorize support with a filing under R14-2-103 or other method as the Commission may
2 prescribe.”⁶

3 The question before this Commission is not one of authority or ability under its current
4 rules. The question raised by opponents of the ALECA intrastate access-reform proposal
5 (one of three proposals I presented in my Direct Testimony) is one of public policy. It
6 would be sound public policy to permit ALECA members to shift intrastate access
7 revenues from the current intrastate access-charge regime to a revenue-neutral AUSF
8 mechanism without the economic and administrative burdens associated with an
9 intrastate rate case. This maximizes the public benefit, while minimizing the burden on
10 ALECA members.

11 It would not be sound public policy to delay the public benefit of access reform and
12 require each ALECA member to endure a costly and time consuming rate case to perform
13 a revenue-neutral shift in revenues.⁷ Nor would this conserve the scarce resources of the
14 Commission, its Staff, RUCO, and other interested parties.

15 **Q: WHAT ARE YOUR NEXT ISSUES WITH STAFF?**

16 **A:** I found three apparent inaccuracies on Exhibit WMS-1.

17 First, the exhibit shows Navajo Communications as concurring in Qwest rates. This is
18 not correct. Since the exhibit does not have a source, I was unable to determine exactly
19 how Staff made this finding.

20 Second, the exhibit lists Qwest rates and recognizes that transport is mileage sensitive,
21 yet for the mileage category exceeding 50 miles it is unclear how Staff calculated its

⁶ *Id.* at 13:27-14:1. (Emphasis supplied.)

⁷ Staff presents another option where ALECA members “absorb access charge reductions” without any increase in AUSF. This option is a non-starter for most ALECA members because the ability to continue to invest and maintain their networks would be impeded by following this recommendation.

1 origination or termination rates per minute. I believe that the Qwest statewide composite
2 charge for intrastate switched access service exceeding 50 miles is \$0.022 per minute.⁸

3 It appears that Exhibit WMS-1 incorrectly calculates Qwest rates without taking into
4 consideration the average length of haul used in transport service.

5 Third, there are discrepancies between certain access rates listed in Exhibit WMS-1 and
6 the access rates for Frontier Communications of the White Mountains. The correct rates
7 are \$0.024248 for the originating Carrier Common Line ("CCL") charge and \$0.104604
8 for the terminating CCL charge.⁹

9 **Q: STAFF SUGGESTS THAT SUBSCRIBER LINE CHARGES ARE USED IN THE**
10 **FEDERAL ARENA TO ELIMINATE INTERSTATE NON-TRAFFIC SENSITIVE**
11 **CHARGES. DO YOU AGREE WITH STAFF'S DESCRIPTION?**

12 **A:** Not entirely. Mr. Shand discusses the use of federal subscriber line charges and suggests
13 that a similar approach would eliminate the need for intrastate access recovery through
14 the AUSF.¹⁰ Reform of rural federal interstate access involved more than increasing
15 end-user common line charges. Specifically, the Federal Communications Commission
16 devised a mechanism that increased the federal SLC and established a new federal
17 universal service mechanism—the Interstate Common Line Support—that provided for a
18 revenue-neutral shift of interstate access charges to a universal service program.

19 The use of universal service to reform access has been used in the federal arena for rural
20 carriers and by other state regulatory authorities to reform intrastate access. Exhibit
21 DDM-R2 is a copy of a recently released report from the National Regulatory Research

⁸ Meredith Direct at 7:11-21. I recommended that \$0.022 per minute be the target rate for ALECA members. ALECA members would be required to demonstrate using 2008 data that their composite intrastate access rate would equal this amount. The remaining intrastate switched access revenue for 2008 would be shifted to the AUSF.

⁹ Frontier Communications of the White Mountains Access Tariff No. 1, Section 3.8, 1st Revised Page 110.

¹⁰ Shand Direct at 4:5-14.

1 Institute ("NRRI") entitled "State High Cost Funds: Purposes, Design and Evaluation."
2 NRRI surveys the high-cost funds various states have established to support carriers
3 serving high-cost areas. The New Mexico Rural USF and the South Carolina Interim
4 LEC Fund are especially noteworthy examples of state funds that have acted to replace
5 carrier revenues in connection with access reform.¹¹ They are very similar to the
6 ALECA proposal, which provides a streamlined method for this Commission to reform
7 intrastate access charges in a revenue-neutral manner.

8 **Q: STAFF OPPOSES USING THE AUSF TO DEFRAY THE COSTS OF HAVING**
9 **THE ARIZONA DEPARTMENT OF ECONOMIC SECURITY ("ADES")**
10 **CENTRALLY ADMINISTER THE LIFELINE AND LINK-UP PROGRAMS; DO**
11 **YOU AGREE?**

12 **A:** No. Mr. Shand claims that incumbent LECs would benefit by \$38M annually if DES
13 centrally administered Lifeline and Link-Up and automatically enrolled qualified
14 applicants.¹² It appears that Mr. Shand has misinterpreted who would be the ultimate
15 beneficiaries.

16 Mr. Shand appears to be relying on a report entitled "The Report and Recommendations
17 of the Eligible Telecommunications Carriers on Lifeline and Link-Up Issues," which
18 states that centralized administration and automatic enrollment of Lifeline and Link-Up
19 would bring 400,000 new enrollees into the program and "... over \$38M in annual
20 federal aid into the State of Arizona for the benefit of low-income consumers."¹³

21 However, it is important to recognize that the federal support in the form of lifeline and
22 link-up funds would flow directly to the end-user customer, not the ILECS.

¹¹ See Exhibit DDM-R2 - NRRI, "State High Cost Funds: Purposes, Design, and Evaluation" at pages 119-121 and 128-130.

¹² Shand Direct at 26:1-12.

¹³ "The Report and Recommendations of the Eligible Telecommunications Carriers on Lifeline and Link-Up Issues," Docket No. T-00000A-05-0380, December 21, 2005, at page 12. (Emphasis supplied.)

1 I strongly recommend the Commission adopt the centralized administration program I
2 explained in my Direct Testimony. There is no downside and all parties would benefit.

3 **IV REPLY TO QWEST**

4 **Q: QWEST MAINTAINS THAT IT RECEIVES NO FEDERAL SUPPORT FOR**
5 **SERVING RURAL CUSTOMERS IN ARIZONA;¹⁴ IS THIS AN ACCURATE**
6 **STATEMENT?**

7 **A:** No. Based on the Universal Service Administrative Company's latest projections for the
8 first quarter of 2010, Qwest is projected to receive \$11M annually of federal high-cost
9 support in the form of Interstate Access Support ("IAS").¹⁵ These funds are to be used to
10 offset Qwest's costs to serve rural Arizona. When the FCC adopted the Coalition for
11 Affordable Local and Long-Distance Services ("CALLS") plan, Qwest—and other
12 primarily non-rural carriers regulated under a price cap mechanism for interstate
13 purposes—received IAS to offset interstate access-rate reductions. IAS support was
14 designed to help offset decreases in interstate access charges adopted by the FCC for
15 price-cap carriers. Of particular interest, the IAS support was provided without requiring
16 any sort of earnings tests or rate-case filings.

17 **Q: DO YOU AGREE WITH QWEST'S PROPOSAL TO ESTABLISH A LOCAL**
18 **RESIDENTIAL RATE BENCHMARK RATE AT 125% OF THE STATEWIDE**
19 **AVERAGE?**

20 **A:** No, there is no need for this benchmark. While individual ALECA member's rates range
21 above and below the proposed benchmark, the composite local rate of ALECA is already
22 comparable to the statewide average for local residential service. The composite rate for

¹⁴ Copeland Direct at 3:10-11.

¹⁵ Universal Service Administrative Company, <http://www.universalservice.org/about/governance/fcc-filings/2010/quarter-1.aspx>, High Cost Support with Capped CETC Support Projected by State by Study Area, HC-01.

1 local residential service for ALECA members is \$12.91. The weighted average
2 residential retail rate of ILECs in Arizona is \$13.16. The ALECA weighted average rate
3 is 98 percent of the statewide rate—without accounting for local calling scope. The
4 current ALECA average rate is comparable to the Arizona statewide average.

5 **Q: SHOULD ALECA MEMBERS WITH RATES LOWER THAN 125% OF THE**
6 **STATE-WIDE AVERAGE BE REQUIRED TO INCREASE RATES TO THE**
7 **RECOMMENDED BENCHMARK?**

8 **A:** No. When analyzing local rates, a critical factor to be considered is the local calling
9 scope or toll-free calling available to the customer for the local service rate. Qwest is the
10 largest urban carrier in the state and provides service to areas such as Flagstaff, Phoenix,
11 and Tucson. Qwest's highest urban rate is \$13.18. The ALECA members with local
12 service rates below the benchmark proposed by Qwest serve rural areas in Arizona such
13 as Bullhead City, Bonita, Clifton, Colorado City, Supai, and Salome. The local calling
14 area for these rural customers is not comparable to that available to Qwest's customers.

15 It would be unfair to require ALECA member's customers to pay 125% of the statewide
16 average rate. In addition to being affordable, local rates should be comparable for similar
17 services. The Federal Telecommunications Act of 1996 ("Act"), for example, states that
18 quality services should be available in high-cost areas at just, reasonable, and affordable
19 rates. The Act also suggests local rates should be reasonably comparable to rates charged
20 in urban areas for similar services. The rates in effect today for the ALECA companies
21 align with this public policy. Requiring ALECA members to raise their local-calling
22 rates would require their customers to pay more for less.

1 **Q: WHAT DO YOU THINK OF QWEST'S CONTENTION THAT HIGH COST**
2 **FUNDING FOR LOOPS IS AVAILABLE THROUGH THE CURRENT AUSF?¹⁶**

3 **A:** Currently, funding from the AUSF has only been available to companies after they
4 submit to the protracted and costly rate case process detailed in ACC Rule R14-2-103.
5 This requirement is a major hurdle to companies operating in rural and remote areas of
6 the state, as evidenced by the fact that only one company has ever gone through the
7 process to receive support in the history of the AUSF. The method proposed by ALECA,
8 using the information provided for the federal High Cost Loop Support algorithm is
9 readily available and would provide sufficient accountability prior to the approval of
10 AUSF funding for loops. This would result in a more reasonable process and an increase
11 in funding where it is needed most—in rural and remote areas.

12 **V REPLY TO VERIZON**

13 **Q: DO YOU AGREE WITH VERIZON'S SUGGESTION THAT ANY REVENUE**
14 **LOSS DUE TO STATE ACCESS REFORM SHOULD BE RECOVERED FROM**
15 **EACH COMPANY'S END-USER CUSTOMERS THROUGH RETAIL PRICING**
16 **FLEXIBILITY?¹⁷**

17 **A:** No. Adoption of Verizon's recommendation would result in unreasonably high local
18 rates for the ALECA companies. The current composite ALECA local rate is \$12.91 per
19 month. Recovering the lost state access revenue from end-user customers without AUSF
20 funding, would require ALECA to increase its composite rate by \$10.74. This would
21 result in a monthly composite rate of \$23.65, which far exceeds the weighted residential
22 retail rate in Arizona. This would be a far greater increase than the one proposed by
23 Qwest, so it would make even less sense.

¹⁶ Copeland Direct at 9:21-22.

¹⁷ Price Direct at 4:2-3.

1 **Q: DO YOU AGREE WITH VERIZON THAT EXPANDING THE AUSF IS NOT**
2 **THE PURPOSE INTENDED BY THE COMMISSION?**

3 A: No. Expanding the AUSF to allow for a revenue-neutral draw of support will serve the
4 very purpose for which it is intended—to keep local rates affordable. The purpose of the
5 AUSF is to keep local rates from exceeding an affordable local benchmark as determined
6 by the Commission. As noted in my response above, expanding the AUSF is necessary
7 to maintain reasonable local rates for the ALECA members.

8 **Q: DOES VERIZON RECEIVE ANY FORM OF HIGH COST SUPPORT?**

9 A: Yes. In reviewing USAC's latest projections for the first quarter of 2010, Verizon is
10 scheduled to receive over \$225 million nationwide in annual federal support, and over
11 \$458,000 of annual federal support in Arizona alone.¹⁸ Verizon and other price-cap
12 carriers receive Federal IAS support to offset interstate access rates associated with the
13 FCC's CALLS Order. As I mentioned earlier, Verizon received this support without
14 undergoing any earnings reviews or filing any rate cases.

15 **VI REPLY TO RESIDENTIAL UTILITY CONSUMER OFFICE (RUCO)**

16 **Q: DR. JOHNSON CONTENDS THAT AT&T AND OTHER INTEREXCHANGE**
17 **CARRIERS ARE CLAIMING THAT THEY SHOULD BE ALLOWED TO USE**
18 **LOCAL NETWORKS FOR FREE; IS THIS ALECA'S POSITION?**

19 A: No. As I presented in my Direct Testimony, ALECA's position is that its members'
20 intrastate switched access rates should be reduced to the level of Qwest's intrastate
21 composite access rate level, not eliminated altogether, and that the consequent reduction
22 in intrastate revenue should be offset by drawing on the AUSF. I also described the
23 significant policy benefits from taking this important step to bring the ALECA members'

¹⁸ Universal Service Administrative Company, <http://www.universalservice.org/about/governance/fcc-filings/2010/quarter-1.aspx>, High Cost Support with Capped CETC Support Projected by State by Study Area, HC-01.

1 intrastate per minute switched access rate composite to the level of Qwest's composite
2 intrastate per minute switched access rate.

3 **Q: DR. JOHNSON ARGUES THAT THE MORE USERS A NETWORK LINKS**
4 **TOGETHER, THE MORE VALUABLE THE SERVICE IS FOR EACH AND**
5 **EVERY USER; DO YOU AGREE?**

6 **A:** Yes. Keeping ALECA's rural telephone customers on the network is exactly why AUSF
7 support is needed to replace the revenue lost from reducing intrastate access rates and
8 help defray the high costs of rural service. Not only would ALECA's rural subscribers
9 benefit from such AUSF support but their urban counterparts would also benefit by being
10 able to continue to reach and be reached by rural users.

11 **Q: DR. JOHNSON CLAIMS THAT TECHNOLOGICAL IMPROVEMENTS AND**
12 **INCREASING SCALE ECONOMIES HAVE RESULTED IN SHARP**
13 **REDUCTIONS IN PROVIDING MOST TELECOMMUNICATIONS SERVICES;**
14 **DO YOU AGREE?**

15 **A:** No, this has not been ALECA's experience. Although switching costs have fallen with
16 technological advances, the costs of placing aerial and buried cable and constructing
17 outside plant structures have increased. Because of lower population densities, cable and
18 plant costs are also proportionately higher for ALECA's members. One mile of cable
19 could serve hundreds if not thousands of customer in Qwest's urban areas. By contrast,
20 one mile of cable may well serve far fewer than a hundred customers, even as few as one
21 customer per mile.

22 Dr. Johnson also ignores how competition is eroding revenues. Like similar incumbent
23 LECs all across the country, ALECA member companies have lost access lines to
24 competitors (e.g., wireless carriers and VoIP service providers). At the same time, the

1 high fixed costs of local telephone service in a specific geography have not fallen as
2 quickly (if at all) as line losses, thereby tending to raise the cost per access line.

3 **Q: DR. JOHNSON RECOMMENDS THE COMMISSION LOOK CLOSELY AT**
4 **HOW THE GROWTH IN UNREGULATED SERVICES AFFECTED THE**
5 **SHARE OF NETWORK COSTS BORNE BY REGULATED, INTRASTATE**
6 **SERVICES;¹⁹ DO YOU AGREE?**

7 **A:** No. The FCC has prescribed elaborate rules for allocating incumbent LECs' accounting
8 costs between regulated and unregulated activities.²⁰ ALECA's member companies
9 participating in these proceedings all comply with these FCC's rules. Therefore any non-
10 regulated activities of the ALECA members have already been removed and should not
11 be a factor in this proceeding.

12 **VII REPLY TO AT&T**

13 **Q: DRS. ARON AND OYEFUSI RECOMMEND BENCHMARK RATE**
14 **MECHANISMS IN CONJUNCTION WITH ACCESS RATE REFORM. DO YOU**
15 **AGREE WITH THEIR ANALYSIS?**

16 **A:** No. As I said in my Direct Testimony, establishing a revenue benchmark is not
17 necessary to begin intrastate switched exchange access reform in Arizona. A revenue-
18 neutral shift of revenues from intrastate access to a high-cost universal service fund
19 provides for expedited reform, without adding complications related to establishing a
20 benchmark.

21 **Q: DOES THIS CONCLUDE YOUR REPLY TESTIMONY?**

22 **A:** Yes.

¹⁹ Johnson Direct at 29:11-13:21-25.

²⁰ See 47 CFR Part 64.

Procedural Order Issues List

1. What carriers should be covered by access reform?

The focus of these dockets should be preserving and promoting the widespread availability and affordability of basic local exchange service in the territories of rural ILECs in Arizona. Consequently, narrowing the disparity between ALECA members' intrastate and interstate access rates in a revenue neutral manner should be the Commission's first priority. However, ALECA is not opposed to addressing CLEC access charges in these dockets, provided doing so does not distract from the primary focus. ALECA has proposed using Qwest's intrastate access rates as a target of access reform for its member companies and acknowledges it may be more appropriate for Qwest's access rates to be the subject of a separate proceeding.

2. To what target level should access rates be reduced?

Assuming revenue-neutral replacement financed through the AUSF, bringing rural ALECA members intrastate access rates into equality with Qwest's intrastate access rates is an important step in eliminating the wide and ever widening disparity between ALECA members' interstate and intrastate rates; however, eliminating the CCL rate element is also an important step in the right direction.

3. What procedures should the Commission implement to achieve the desired reduction in access rates?

ALECA recommends the Commission adopt ALECA's recommendations and then institute a rule-making, as needed, to approve the proposed rules filed with ALECA's direct testimony.

4. Should carriers be permitted to contract for access rates that differ from their tariffed rates?

Yes, provided the terms and conditions of the individual contracts do not discriminate against other carriers.

5. What revenue sources should be made available to carriers to compensate for the loss of access revenue?

The central issue in this proceeding should be the preservation and promotion of basic local exchange services provided by rural ILECs in Arizona. Any revenue reduction not recovered from local rates should be compensated by the AUSF. The areas served by the ALECA members are predominately rural and costly to serve. The foregone state access revenues must be replaced to enable rural carriers to continue investing and maintaining local exchange facilities in these high-cost areas. Provided access reform is revenue neutral, there should be no need for rural companies to file rate cases in order to recover lost revenues from the AUSF.

6. How much of access cost recovery, if any, should be shifted to end users? What showing should be required for such a shift? What should be the role of "benchmark" rates, and how should benchmarks be set?

Although this is not ALECA's recommendation, if the Commission finds that local rate increases are considered a necessary element of access reform, the amount of access revenue reductions

shifted to end users should be based on the statewide average residential rate. ALECA proposes that its members not be required to increase local residential rates higher than \$11.84 per month, which is 90 percent of the residential state-wide average rate ($\$13.16 \times 0.90 = \11.84). The role of such a benchmark is to establish a reasonable local rate that ALECA members must charge or impute, prior to receiving AUSF dollars. ALECA believes that 90 percent of the statewide average is reasonable when calling scopes are considered. This is not a revenue increase; therefore no earnings reviews or rate cases should be required prior to this local rate change. Shifting local rates to the benchmark is the first step in a revenue neutral rate rebalancing process.

The median number of access lines served by ALECA members is approximately 4,500. It is not possible to raise local and other retail rates enough to compensate for the loss of revenue from bringing intrastate access rates into equality with interstate rates. The customer base of ALECA members is not even large enough to absorb a significant portion of the revenue shift required to rebalance access rates on a revenue neutral basis. ALECA-member local rates would increase substantially, perhaps even double, if required to absorb the entire amount of the revenue lost to move state access rates closer to interstate levels. ALECA members depend heavily on access revenues and would experience significant economic hardship if rate rebalancing were not a revenue neutral process.

7. Procedurally, what will be required of a carrier if it seeks a "revenue neutral" increase in local rates?

Each carrier should be required to demonstrate the amount of revenue foregone from access rate reductions using the access volumes from a base year as a starting point. The difference is the amount each carrier would be entitled to recover from the AUSF.

8. Assuming that AUSF funds will also be used as a compensating revenue source, what specific revisions (including specific recommended amendment language) to the existing rules are needed to allow use of AUSF funds for that purpose?

ALECA proposed specific recommended AUSF rule amendments in its direct testimony.

9. Which carriers should be eligible for AUSF support?

ALECA has proposed revenue-neutral access reform for rural ILECs and support for high-cost loops similar to the FCC's High Cost Loop program, both financed through the AUSF. Accordingly, ALECA's preferred position is that the Commission confine access revenue replacement and high-cost loop support to rural carriers as defined by the Telecom Act of 1996.

Alternatively, ALECA is not opposed to allowing CLECs and wireless carriers access to the AUSF for high-cost loop support purposes to the extent that they serve customers within the service territory of rural ILECs, provided they obtain ETC designation and any support is based on their own costs.

Carriers that do not have public service obligations consistent with universal service objectives should not receive support.

10. What should be supported by the AUSF? Access replacement only? High cost loops? Line extensions? Centralized administration and automatic enrollment for Lifeline and Link-Up?

The AUSF should be utilized for revenue-neutral access replacement and to support high-cost loops. The ALECA members serve some of the most rural areas of the country and the AUSF should naturally be used to ensure universal service to these areas. ALECA also supports the recommendation of the industry ETC's, that the AUSF should pay the costs of centralized administration and automatic enrollment.

The central issue in this docket is preserving and promoting the widespread availability and affordability of basic local exchange service in rural Arizona. The AUSF should support basic local exchange services, support intrastate access charge reform, and help defray the costs of certain line extensions. The existing contribution from state switched access revenues defrays a significant portion of the costs ALECA members incur supplying basic local exchange service in rural Arizona. In fact, the ALECA members' financial survival depends on access-charge revenues. Any state access reduction must be offset with an increase in AUSF and/or local rates. This revenue-neutral offset is critical to the ALECA member's ability to maintain universal service obligations. High-cost loop support provides ALECA member companies with the ability to extend facilities to serve rural residents. As the rural ILEC's cost per loop increases in relation to the national average, or federal loop support declines, ALECA's proposal will provide rural ILECS with greater support. Finally, ALECA believes automatic enrollment of Lifeline and Link-Up is the most effective means of reaching qualified households. The AUSF should be used to fund the centralized administration required to achieve this objective.

11. What should be the basis of AUSF contributions and what should be the structure of any AUSF surcharge(s)?

All carriers providing intrastate retail telecommunications services should contribute to the AUSF. The surcharge would be based on the ratio of each carrier's intrastate retail revenues to total intrastate revenues provided by all carriers. Should the FCC change its USF financing mechanism to a connections-based contribution factor, ALECA recommends this Commission adopt a similar funding mechanism for the AUSF.

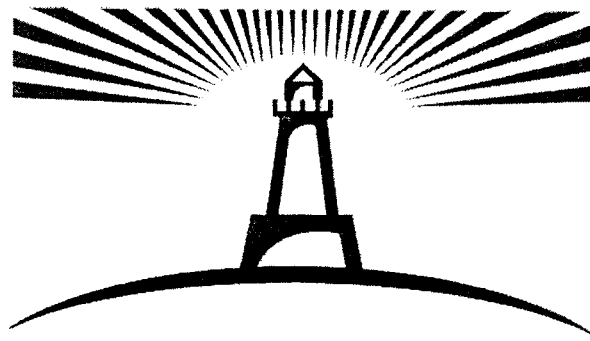
While ALECA also finds the current three-part AUSF surcharge mechanism broad-based and equitable, it is apparent from experience in other states that in-state toll revenues represent a declining source of contributions to state programs. Secondly, a revenue-based surcharge may be viewed as superior from the standpoint of competitive neutrality.

12. Any other specific revisions to the AUSF rules?

ALECA attached proposed rule amendments to its Direct Testimony.

Reply Testimony of Douglas Duncan Meredith
Arizona Corporation Commission
February 4, 2010
Exhibit DDM-R2





National Regulatory
Research Institute

**State High Cost Funds:
Purposes, Design, and Evaluation**

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We appreciate the work done by the many staffers at state utility commissions who took the time to answer our written survey. We also conducted telephonic interviews with state staff members from many states, most of which operate high cost funds, and we want to offer our particular gratitude to those many staffers: Lori Kenyon in Alaska; Will Shand in Arizona; Bill Dennis, Cindy Ireland, and Art Stuenkel in Arkansas; Charles Christianson, Robert Haga, Larry Hirsch, Roxanne Scott, and Donna Wong in California; Larry Herold and Susan Travis in Colorado; Grace Seaman in Idaho; Jefferey Hoagg and Jim Zolnierrek in Illinois; Sally Getz in Indiana; Sandy Reams in Kansas; Rich Kania and Joel Shifman in Maine; Sue Vanicek in Nebraska; Charlie Bolle in Nevada; Greg Pattenau in New York; Ken Smith in New Mexico; Bennett Abbott in Oklahoma; John Tatum and Roger White in Oregon; Elizabeth Barnes in Pennsylvania; Doug Pratt in South Carolina; Jay Stone in Texas; Bill Duncan and Casey Coleman in Utah; Peter Jahn in Wisconsin; and Art Schmidt in Wyoming. Finally we want to thank David Rolka of Rolka, Loube, Saltzer Associates for helping us better understand the operations of the Arkansas high cost fund.

Online Access

This paper can be found online at
www.nrri.org/pubs/telecommunications/NRRI_state_high_cost_funds_jan10-04.pdf.

Executive Summary

Universal service remains a concern of state legislatures and commissions as policy makers seek to maintain ubiquitous and affordable basic telephone service. One strategy is to establish a high cost fund to provide support for carriers serving high-cost areas. This report focuses on these state funds, analyzing the steps involved in establishing and maintaining them. The report, which is intended for state commissions and state legislatures that are considering adopting a fund, explains why these funds typically have been created and discusses how those varying purposes are reflected in support mechanisms. The report is also intended for states that already have such funds but are considering changes to improve their function or effect. States also use other universal service programs such as Lifeline and school and library programs, but those programs are not the subject of this report.

The authors base their findings on the experiences of the twenty-one states that currently operate high cost funds, as well as on insights provided by states that do not. Information for the report was gathered from a survey of commissions in all 50 states, the District of Columbia, and the Virgin Islands; from interviews with commission staff at the twenty-one states now operating high cost funds; and from independent analysis of state statutes, rules, and decisions. Overviews of each of the twenty-one high cost funds are provided in Appendix B of the report.

Several factors influence the need for a state high cost fund:

- The status of competition in the state. Wireless and VoIP providers are winning subscribers from Incumbent Local Exchange Carriers (ILECs). These are often subscribers in competitive low-cost areas or high-volume business users. Losing such customers increases the ILEC's average cost of serving its remaining customers. Support from a high cost fund can help ensure affordable rates for customers in the high-cost areas in which there is no robust competition.
- Continued importance of ILECs. While a network without ILECs can be imagined, for the foreseeable future ILECs will continue to play a unique role, often functioning as a carrier of last resort and providing essential carrier-to-carrier services. ILEC failure would create hardships for subscribers and other carriers.
- Erosion of traditional revenues. ILECs have three main revenue streams: subscriber revenues, intercarrier revenue, and federal universal service support. Each of these revenue streams faces risk. Subscriber revenues are declining because of competition. Intercarrier revenue is decreasing because of declining volume and regulatory decisions that lower rates. Possible reductions in federal universal service present a business risk to ILECs that serve high-cost areas. Some states have established high cost funds to replace some of these lost revenues.
- Erosion of implicit support. Local rates, especially rural local rates, have traditionally been kept low through implicit support mechanisms like urban-to-rural support flows, toll-to-local support flows, and business-to-residential support flows. Competition has put pressure on all of these support flows. A high cost fund can replace some of these support flows.

- The distribution of costs across the state. Small wire centers, which are often rural, incur higher costs than large wire centers. While a state with a homogeneous distribution of costs across its wire centers would not be likely to need a high cost fund, a state with a combination of high-cost and low-cost areas could benefit from a fund that would provide support to the high-cost areas.

Once a state decides to establish a fund, a fundamental issue is which carriers will be eligible for support. Some states define eligibility by classifying carriers. Several states, for example, have limited support to rural ILECs. Other states, following the federal model for designating Eligible Telecommunications Carriers (ETCs), determine eligibility through a designation process, using a list of supported services and often asking carriers to demonstrate or attest to their ability to fulfill specific functions.

Competitive carriers are not always eligible to apply for high cost support. Some states specifically exclude them. In several states, competitive carriers have chosen not to apply for designation. If a state decides to make competitive carriers eligible to receive support, an important consideration is how that support will be calculated. A few states base a competitive carrier's support on the carrier's own costs; other states follow the identical support rule and base support on ILEC costs. Following the identical support rule can lead to a much larger fund size.

The twenty-one states that currently have high cost funds use (or have considered using) four modes to distribute state support:

- Hold-harmless mode: This mode seeks to minimize the financial impact of regulatory change on a carrier, or category of carriers. States have created high cost funds to replace revenues lost as a result of access charge reductions or changes in regulatory rules. Some states limit the amount of support provided by establishing benchmark rates for local service. The amount of support is decreased by the amount of revenue a carrier can realize by raising local rates to the benchmark.
- Cost-based mode: This mode provides support to help defray the cost of providing service in high-cost areas. Support is calculated using either embedded costs or forward-looking costs. Some states use an embedded-cost approach for rural carriers and a forward-looking cost approach for larger, non-rural carriers. As with the hold-harmless approach, many states limit support through the use of benchmarks for local rates. A major issue is whether to include costs related to broadband infrastructure.
- Bill credit mode: Carriers provide explicit bill credits for customers who would otherwise pay retail rates above a specified benchmark. The high cost fund then reimburses the carriers for the bill credits.
- Auctions: Support is determined through competitive bidding. No state has as yet formally adopted this approach.

Contributions to high cost funds are collected through *ad valorem* surcharges on retail telecommunications services, with virtually all states with high cost funds levying those surcharges on intrastate services only. (Appendix D discusses the issue of applying surcharges

to total revenues.) About half of the states with high cost funds levy the surcharge on carriers' retail revenues, or gross receipts, while the other half apply the surcharge on customers' retail charges. Typically, ILECs, wireline competitive carriers, and interexchange carriers are contributors to high cost funds. Wireless providers and fixed VoIP providers are required to contribute in some states. The issue of whether nomadic VoIP providers should contribute is unresolved.

A few states administer their high cost funds internally, giving that task to the regulatory commission or a combination of state agencies. Most states turn to an external agency (either an industry coalition or a third-party administrator) to be the fund administrator and custodian.

States considering whether to establish a high cost fund should consider the following questions:

- Is a fund needed?
- Is there legal authority for a fund?
- What are the fund's goals?
- What services, providers, and facilities should be supported?
- What distribution mechanism is best?
- Are controls needed over fund size?
- How will funds be collected?
- Who will administer the fund?
- How will the fund be evaluated and made accountable for results?

Competition, technological advances, and shifts in consumer preferences have all weakened some of the tools that states have traditionally used to maintain ubiquitous and affordable local telephone service. The authors hope this report will provide insights for policymakers and practitioners seeking to find new mechanisms to address their universal service goals.

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State High Cost Funds: Their Purposes, Design, and Evaluation

I. Introduction and Background

A. Purpose and scope

“Universal service” is a broad concept with many meanings. This paper covers only the principal definition: state-supervised mechanisms for collecting and distributing funds with the aim of supporting telecommunications services in high-cost areas. Common goals are to ensure that basic telephone service is ubiquitous and adequate in rural areas and that rates for basic service are affordable. Many states maintain funds that provide support for other kinds of universal service programs, including Lifeline programs for low income customers and support for schools and libraries. Those non-high-cost programs are beyond the scope of this paper.

This report is intended for state commissions and state legislatures that are considering adopting a state universal service fund to support telecommunications services in high-cost areas. The report explains why state high cost funds typically have been created and how those varying purposes are reflected in high cost support mechanisms. The report also discusses the means of obtaining revenues for such funds, as well as how funds can be best administered and evaluated.

The report is also intended for states that already have such funds but are considering changes to improve their function or effect. Even where a state is not actively considering establishing a new program or changing an existing program, this report aims to provide information about when and how such programs might become necessary.

B. The survey and interviews

During the first four months of 2009, the authors distributed a survey to the commissions in the fifty states, the District of Columbia, and the Virgin Islands. We used two survey instruments, a detailed form for states with high cost funds and a briefer form for other states. We asked about how the programs operate, whether the states have concerns with their current programs, and whether they operate other universal service programs.

Of the 52 commissions contacted, 46 states, the District of Columbia, and the Virgin Islands responded to the surveys.¹ We conducted interviews with responsible staff in all the states with state high cost funds. The findings below are based on these survey responses and interviews as well as on independent research into state statutes, rules, and decisions.

¹ Delaware, Hawaii, Louisiana, and Texas did not participate in the survey. Texas has a high cost fund, and the authors conducted a lengthy interview with staff of the Public Utility Commission of Texas.

II. Overview of State High Cost Funds

A. States with funds

High cost funds consist of mechanisms for collecting money under authority of law and other mechanisms to distribute those funds to support ubiquitous, adequate, and affordable voice service in high-cost areas. Collection mechanisms include surcharges of varying types on telecommunications services, including retail surcharges on end users, surcharges on the revenues of providers, per-line charges on Local Exchange Carriers (LECs), and per-minute charges imposed on Interexchange Carriers (IXCs).²

The following pages cite illustrative experiences of selected states. Appendix B contains detailed descriptions of the procedures and policies followed by the twenty-one states that operate high cost funds. The states with high cost funds are listed in Table 1.

Table 1. States with High Cost Funds

State	Year established
Alaska	1999
Arizona	1989
Arkansas	1997
California	1988 (A Fund); 1996 (B Fund)
Colorado	1990
Idaho	1988
Illinois	2001
Indiana	2007
Kansas	1997
Maine	2002
Nebraska	1999
Nevada	1995
New Mexico	2006 (earlier fund in 1987)
Oklahoma	1996
Oregon	2000
Pennsylvania	2000

² High cost funds differ from pooling arrangements. In pooling arrangements a rate for a specific service (or for specific services), such as toll or access charges, is based on the total relevant costs of all the carriers who provide the service and are members of the pool. The carriers all bill the established rate and report the resulting revenue to the pool. Each carrier's share of the resulting revenue is then distributed based on the carrier's costs. In a high cost fund, designated categories of service providers pay into a fund from which only those carriers that meet specific eligibility requirements can receive support.

State	Year established
South Carolina	2003
Texas ³	1987
Utah	1997
Wisconsin	1996
Wyoming	1997

Most of the funds were set up after the passage of the federal Telecommunications Act of 1996 (TA96). California's "A Fund" and funds in Arizona, Colorado, Idaho, Nevada, and Texas were created before 1996.⁴ About half of the funds were created between 1996 and 1999. Seven states created funds in 2000 or thereafter. Indiana created the newest fund in 2007.

Twelve state funds were created directly by statute or by the commission acting under a statutory mandate (three states and the California B Fund). The California A Fund and the Alaska, Arizona, Indiana, and Pennsylvania funds were established by state commission initiative.

B. States without funds

Twenty-nine states, the District of Columbia, and the Virgin Islands do not have state high cost funds. Twenty of those states, the District of Columbia, and the Virgin Islands reported that they had considered, but had not established, such a fund. The most commonly reported reason for rejecting a fund was the absence of a perceived need.

- The Michigan Telecommunications Law specified that the state commission should establish a high cost fund only if it could be demonstrated that the long-run economic cost of providing service would exceed the affordable rates for a supported service. None of the carriers in the state subsequently claimed that this condition was satisfied.
- In North Carolina, the state commission in 1998 initiated a proceeding regarding universal service. At the request of two incumbent local exchange carriers (ILECs), the commission suspended that proceeding. No one has subsequently asked that the matter be reconsidered.

³ Information about the Texas high cost fund was collected through a lengthy interview with commission staff.

⁴ New Mexico established a state fund in 1987 that never distributed support. New Mexico established its current fund in 2006.

Some states that do not have high cost funds have established other mechanisms to achieve some of the objectives of a high cost fund.⁵ These mechanisms continue to rely on intrastate access charges imposed on IXCs⁶ as a means of providing implicit support to high-cost local telephone companies.⁷ In some states these access charge revenues are pooled and a common rate is charged, while in other states the LECs charge company-specific rates. Kentucky and Washington use intrastate access surcharges rather than explicit payments to support high-cost areas.

As another example, the New York commission created an interim mechanism in 2003 to help carriers transition away from an intrastate access settlement pool.⁸ The New York Transition Fund provides cost-based support to three small ILECs.⁹ At this writing, New York no longer collects funds for this program, although the fund balance will not be depleted until 2011. The New York commission has opened a proceeding to consider establishing a statewide high cost fund.¹⁰

C. Recent changes to high cost funds

Our survey asked states with high cost funds whether they had made substantive changes to their funds during the last three years. Only a few reported making such changes.

- Arkansas reported that it had shifted its distribution calculation from a hold-harmless approach to a cost-based approach.¹¹
- California, Kansas, Nebraska, and Pennsylvania reported changing the surcharge amounts levied on fund contributors. California lowered the surcharge amount

⁵ These state commissions do not consider these mechanisms to be high cost funds. We agree with that characterization because no charge is imposed on retail lines or retail customers.

⁶ "Access charge" in telecommunications means a per-minute charge imposed by a LEC on an IXC to originate or terminate a toll call on the LEC's network and for which the IXC has the right to bill the customer.

⁷ See section III.B.2 for a discussion of access charges as a source of implicit support.

⁸ This pool allowed ILECs to pool revenues and costs associated with providing intrastate toll services.

⁹ Other petitions are pending.

¹⁰ Case No. 09-M-0527. New York also has a Targeted Accessibility Fund to provide support for state Lifeline, E911, public interest pay phones, and telecommunications relay services.

¹¹ See section IV for an explanation of the hold-harmless and cost-based approaches.

for its B Fund and greatly reduced support to its larger “non-rate-of-return” carriers.¹² Nebraska decreased its surcharge temporarily.

- Colorado simplified its process for determining the support provided to smaller “rate-of-return” carriers, replacing a process requiring general rate cases with a streamlined data collection process.

In 2009, several other states were considering changes to their funds. Some states are contemplating changing the size or focus of the fund, with some states considering fund expansions, while others are considering measures to limit fund size.

- Alaska is considering whether to use its fund to help cover common line costs for carriers of last resort.
- California is considering ways to make its B Fund (which provides support to the larger, non-rural carriers) more competitively neutral, including the use of reverse auctions.
- Colorado has been holding workshops as a precursor to issuing an NPRM that could decrease the size of that fund.
- Pennsylvania is considering fund expansion to keep rural rates affordable and is also considering requiring contributions from wireless and VoIP providers.

¹² California’s B Fund rate in 2005 was 2.60%. The most recent rate is 0.38%.

III. Factors Influencing the Need for a State High Cost Fund

Federal laws and policies affect virtually every aspect of state universal service programs. Section 254 of TA96 is a keystone. It recognizes the states' authority to craft and implement their own universal service plans. Indeed, Section 254 states that there "should be" both state and federal support mechanisms to preserve and advance universal service.¹³ The courts have also recognized the need for a partnership between state and federal universal service programs.¹⁴

TA96 also imposes limits. State mechanisms cannot "rely on" or "burden" federal universal service support mechanisms.¹⁵ In addition, state mechanisms to collect funds for universal service must be "equitable and nondiscriminatory."¹⁶

A. Competition and the importance of ILECs

The primary goal of universal service has been to keep quality local telephone services available to all customers at reasonable rates. Historically, state commissions achieved this goal using a variety of mechanisms that allowed ILECs to reduce the monthly local exchange rates they charged to residential customers. Increasingly over time, support from the FCC became an important mechanism to support universal service as well.

Local exchange competition has dramatically changed the traditional ILEC landscape.

- Wireline local exchange competition began in the 1990s and became national policy with the passage of the Telecommunications Act of 1996. The new competitive local exchange carriers (CLECs) focused on local markets that included high volume subscribers and customers who could be served at low cost. CLECs have been most successful in limited geographic areas where costs are low and business customers are concentrated.
- Cable television systems, beginning in the early 1970s, built cable transmission and distribution facilities in the more densely populated portions of ILEC territories. By the mid-2000s, many cable companies had upgraded their networks to provide higher digital capacities. This made it possible for cable companies to offer Voice over Internet Protocol (VoIP) service, giving many customers a landline alternative to the ILEC for voice service. The new VoIP

¹³ 47 U.S.C. § 254(b)(5).

¹⁴ *Qwest Corp. v. FCC*, 258 F.3d 1191, 1203 (2001).

¹⁵ 47 U.S.C. §254(f).

¹⁶ *Id.*

service was offered, however, only in areas where the cable companies already had networks, generally the more densely populated areas.

- Wireless services have been successful competitors for local exchange service, far beyond what Congress anticipated in 1996. Although many American homes now have wireline and wireless devices, an increasing proportion are wireless-only households. Nevertheless, the wireless choices for many rural customers are limited and the wireless service quality is not always reliable.

With competition, some of the traditional mechanisms for managing local rates lost their effectiveness. Some mechanisms began to appear positively harmful. These competitive changes prompted more than a dozen states to replace traditional universal service mechanisms with new high cost funds aimed at the same universal service goals.

Even with competition, ILECs have retained a unique role in universal service. Many states make ILECs exclusively eligible to receive support from their high cost funds. This reflects an understanding, sometimes implicit, that ILECs continue to be different from competitive providers.

One can imagine a competitive market in which ILECs no longer play a unique role. Consider a case in which a state has found that each of the state's citizens has facilities-based telecommunications service available from multiple providers. All of those services are reliable and adequate. All prices are affordable. Suppose further that the state has found that each provider's network operates independently and without any essential dependencies on any other network or "linchpin" provider. Under these circumstances, a state might seriously consider abandoning all concerns for the survival of a single competitor. If an ILEC were to fail, that failure would create only a minor disturbance in an otherwise smoothly functioning system of interconnected telecommunication networks. Under these facts, to give special consideration to ILECs or any other competitor would be unnecessary, possibly even harmful.

Today's telecommunications network differs in two ways from that hypothetical case.¹⁷

1. Competitive carriers do not serve ubiquitously. In most states, facilities-based wireline competition is limited to enclaves with higher population densities, concentrations of business customers, or both.¹⁸ Wireless service is more widespread than wireline, but even it is usually unavailable or unreliable in remote and mountainous areas. In contrast, most state commissions consider

¹⁷ See Bluhm and Bernt, *Carriers of Last Resort: Updating a Traditional Doctrine*, NRRI Report 09-10 (2009).

¹⁸ In many states competitive carriers do offer local exchange service through resale of ILEC service or purchase of unbundled network elements from ILECs. That, however, does not make the competitive carrier independent of the ILEC's network.

ILECs to be bound by Carrier of Last Resort (COLR) duties. ILECs must provide retail service to all who request it, even in areas that are spurned by competitors.¹⁹ Moreover, ILECs have unique duties to retail customers such as to offer specific rate designs, discounts to certain customers, and service quality guarantees.

2. Telecommunications networks do not function independently. ILECs still have unique carrier-to-carrier duties that are essential upstream inputs (linchpin services) to other carriers, including special access (point-to-point) services, central office collocation, interoffice transport, tandem switching, and operations support systems.²⁰

For these reasons, a business and operational failure by almost any ILEC today would be likely to eliminate the sole voice service available to a substantial number of retail customers. An ILEC failure would also likely cause secondary disruptions in retail services provided by other carriers.

Competition is thus a two-edged sword for universal service. On the one hand, the existence of competitors makes ILECs seem to be no more than one of several varieties of local exchange service provider. From this perspective, it is inappropriate to focus universal service policy solely on ILECs, and it is even less appropriate to provide subsidies to ILECs that cause competitive harm to other providers. On the other hand, even with competition, the law continues to impose important specialized duties on ILECs. From the latter perspective, a state commission may legitimately concern itself with the rates charged by ILECs and may properly take steps to ensure that ILECs survive economically.

Our survey shows that states have generally taken the second choice. Even as local exchange markets have become more competitive, states continue to make ILEC rates and ILEC survival a central goal of their universal service programs. Some states simply declare that only ILECs (and in some cases only small rural ILECs) are eligible to receive that support. A few states nominally authorize support to competitors, but they often establish qualifying standards that have the effect of limiting support to these competitive carriers.

In sum, states considering high cost programs will want to evaluate the geographic extent of competition. The findings can help the state commission to differentiate zones in which competition is robust and where no governmental action is needed from "needy zones" where government intervention is needed to ensure that quality local telephone services remain

¹⁹ There may be exceptions. In some states, ILECs have limited line extension obligations. Customers who are located far away from the ILECs' facility may need to share a portion of the construction costs.

²⁰ Operations support systems are ordering, provisioning, and billing systems that allow competitors to purchase services from the ILEC using computerized interfaces.

available to all customers at reasonable rates. Where a government program is needed, the role of the ILEC remains a key issue.

B. ILEC revenues

A state legislature or commission evaluating that state's need for a high cost fund should evaluate the business risk to ILECs. ILECs generally have three major sources of revenue. Each source affects ILECs differently. Each generates different kinds of risk.

1. Subscriber revenues

Subscriber payments are usually the largest source of ILEC revenue. A major share of subscriber revenue comes from monthly charges for basic telephone service. Yet competition and shifting consumer preferences have eroded those revenues. From December of 1999 to December of 2007, ILEC end user switched access lines decreased from 181.2 million to 129.7 million.²¹ This amounts to a compound annual loss of 4.1 percent each year in the number of subscribers who can pay fixed monthly charges.

State commissions generally do not require new entrants to serve as COLRs. Instead, new entrants are often allowed to decide where and to whom they will offer service. This increases the opportunity for a new entrant to serve only customers who currently make the largest contribution to the ILEC's common cost, a practice sometimes called "cream skimming." New entrants that are not required to serve high-cost areas find such high-contribution customers attractive because the new entrant can offer a lower price than the COLR, earn a higher profit than the COLR, or both.

While increased competition has caused ILECs to lose subscribers, the losses have not been geographically uniform. CLECs have generally concentrated on business customers and those in high-density urban areas. Cable voice competitors have generally offered their services only in areas where they already provide cable service.

When competitors succeed in attracting high-contribution customers, the ILEC loses the customers who can be served at lowest cost. The ILEC's average cost increases and the ILEC becomes less competitive. At that point the ILEC is more likely to claim a need for support from a state high cost fund.

Regulatory changes can also create risks to subscriber revenue. A few states have "rebalanced" or "de-averaged" local service rates, thereby raising rural rates. States have sometimes taken this step to increase the chances for competitive entry in rural areas, although it can also improve the ILEC's competitive position in urban areas. In Wyoming, the resulting

²¹ FCC, Industry Analysis & Technology Division, Wireline Competition Bureau, *Local Telephone Competition: Status as of June 30, 2007* (September 2008), Table 1.

high rural rates suggested the need for a state high cost fund.²² Retail rate redesign also played at least a minor role in the creation of high cost funds in some other states.²³

Other regulatory changes can also create risks to subscriber revenue. A state that expands the size of its local calling areas can also reduce an ILEC's subscriber revenue from toll usage. Idaho and Maine both established their high cost funds in part due to decisions to expand local calling areas.²⁴

Jurisdictional reclassifications can also affect subscriber revenues. The FCC has declared a wide range of services to be either interstate telecommunications services or interstate information services. While these reclassifications do not generally affect a carrier's total revenue, they can reduce intrastate revenue and lead to basic rate increases.

2. Intercarrier revenue

Intercarrier payments are the second major source of ILEC revenue. By one estimate, small rural carriers across the nation typically receive about 29% of their total net telephone company operating revenue from intercarrier payments. For some companies, this percentage is as high as 49% of total net operating revenue.²⁵

A large component of ILEC intercarrier revenue comes from IXCs that use the ILEC networks. Before the breakup of AT&T in the mid-1980s, toll revenue came solely from AT&T, since it was the sole nationwide toll carrier. Using a procedure known as "division of revenues," AT&T allocated some of its toll revenues to the ILECs. The revenue from toll services covered a large share of ILEC fixed costs, thereby allowing the ILECs to reduce rates for basic service.

²² The Wyoming state legislature passed a statute in 1995 directing the state commission to ensure that no telecommunications rates were below cost. This led the commission to de-average local rates. Wyoming created a state high cost fund shortly thereafter that limits the highest rates to 130% of the statewide average rate.

²³ In our survey, the Illinois, Kansas, Maine, Nebraska, and New Mexico commissions reported that retail rate design changes had played a role in their decisions to create high cost funds.

²⁴ A decision to expand local calling areas generally decreases subscriber-paid toll revenues. It also decreases intercarrier revenues from access payments.

²⁵ Raymond Henagan, Statement on Behalf of the National Telecommunications Cooperative Association, before the U.S. Senate Committee on Commerce, Science, and Transportation, April 23, 2008.

After the 1984 breakup of AT&T, the FCC replaced the division of revenues system with the "access charge" system.²⁶ The FCC has rate jurisdiction over access for interstate calls. State commissions have similar jurisdiction over access for intrastate calls. When the access charge system was first established, the FCC and the states continued the former practice of requiring IXCs to make a large contribution to the fixed costs of the LECs. This practice led to high per-minute access rates.

The FCC has also established a mechanism for participating carriers to share some of their interstate intercarrier revenues. The National Exchange Carrier Association (NECA) operates a pool for interstate access revenues. NECA files monthly tariffs on behalf of participating small telephone companies that establish uniform access rates. This simplifies the administrative burdens on these carriers. Participating carriers pool all their interstate access revenues. They receive revenue from the pool based on their interstate revenue requirement. The NECA pool provides a significant share of the operating revenue of some smaller ILECs.

Access revenues have been eroding for many years.²⁷ One obvious reason has been a change in usage patterns. Many states have expanded local calling areas, converting many toll calls to local and eliminating access revenues. Increasing use of cell phones is another factor, as well as the wider local calling areas available from mobile phones.²⁸ Some customers have substituted Internet-based services for traditional switched toll calling.

A general decrease in rates has also caused access revenue erosion. Toll rates are now a fraction of what they were in the 1980s. On the interstate side, the FCC has dramatically revised the access charge structure, greatly reducing the rates and the implicit support generated from toll service. One round of access reductions in the 1980s led to the creation of the "Subscriber Line Charge," which subsequently increased to balance further access charge reductions.²⁹ In 2000 and 2001, the FCC adopted the "CALLS" and "MAG" plans, each of which further

²⁶ "Access charge" in telecommunications means a per-minute charge imposed by a LEC on an IXC to originate or terminate a toll call on the LEC's network and for which the IXC has the right to bill the customer.

²⁷ The FCC has reported that access revenues for the telecommunications industry declined from \$21.4 billion in 1997 to \$11.8 billion in 2005. FCC, *Statistics of Communications Common Carriers, 2005/2006 Edition*, Table 6.19.

²⁸ The FCC has created special interconnection rules for mobile carrier calls that originate and terminate in a single "Metropolitan Trading Area" (MTA). The mobile carrier pays only reciprocal compensation, not access charges. MTA areas are generally larger than local calling areas for landline phones.

²⁹ This fixed customer charge today can be as high as \$6.50 per line per month for residential customers.

reduced interstate access charges for different groups of LECs.³⁰ On these two later occasions, the FCC replaced lost access revenues with revenue from new universal service support programs.³¹

Industry groups supporting the "Missoula Plan" have asked the FCC to mandate further reductions to interstate access rates. The proposal also asked the FCC to assert jurisdiction over *intrastate* access rates, mandating a reduction from the comparatively high rates still authorized in many states.³² During our survey, several states expressed concern about the possibility that the FCC might adopt this proposal.³³

Many state commissions have reduced intrastate access charges. Some states have made minor reductions, as a part of routine rate cases. Other states have enacted more dramatic changes, sometimes by legislation, and sometimes requiring that intrastate rates "mirror" (be equal to) interstate rates.

A third reason behind the erosion of access revenue has been what is often called "phantom" traffic, the increase in calls that lack sufficient information for billing purposes. This problem takes several forms. Some voice calls have insufficient information to identify the jurisdiction of the call or the carrier financially responsible. Some calls are identified as local even though they originated outside the local calling area. In some cases IXCs have simply not paid access bills to ILECs.

States today have at least two reasons to consider further reductions to intrastate access rates. Anticipating that access revenues will decline less if rates are lower, some ILEC groups now advocate for access rate reductions matched with hold-harmless support. A second reason is "traffic pumping," in which LECs increase their access minutes by unusual mechanisms such

³⁰ After CALLS and MAG, all common line costs were recovered from a combination of SLC charges (customer-paid fixed monthly charges), universal service support payments, and, in the case of NECA carriers, revenues from the NECA common line pool.

³¹ The "Interstate Access Support" program provides support for the interstate cost of "price cap" carriers. The "Interstate Common Line Support" program provides support for the interstate cost of other non-price cap carriers.

³² See generally, Liu, *Intercarrier Compensation Reform at Debate: Major Issues of the Missoula Plan*, National Regulatory Research Institute, Report No. 07-05.

³³ Our survey asked whether states had analyzed the potential effects of federal intercarrier compensation reform. California and Washington evaluated the likely impact of federal ICC reform. Several other states are monitoring the issue and filed comments with the FCC. They were particularly concerned that the FCC might not create an adequate revenue replacement mechanism and would thereby harm carriers and customers and increase the financial pressure on state universal service programs. One state said that adoption of the Missoula Plan could lead it to establish a high cost fund for the first time.

as free conference lines. Traffic pumping can greatly increase terminating access volumes and ILEC profits. For these and other reasons, several states reported that they are considering making further reductions to intrastate access rates.

In several states, episodes of access rate reduction have been the proximate cause of a new state high cost fund. As states lowered access rates, they offset some or all of the ILEC financial losses with support from new high cost funds.³⁴ Alaska, Arkansas, Colorado, Illinois, Indiana, Kansas, Pennsylvania, and Wisconsin³⁵ each reported that reductions to access charge rates had influenced their decisions to create high cost funds. This history is not surprising given the strong financial relationship between access charges and local rates. Even today, many carriers derive a major share of revenue from intrastate access and toll.

In sum, the volume and trends in intercarrier revenues are relevant to whether a state needs a high cost fund. If the commission plans to mandate reductions of intrastate access charges, it should evaluate the need for adopting a high cost fund to replace lost revenues.

3. Federal universal service funds

The third major source of ILEC revenue is federal universal service payments. Limiting consideration to programs aimed at supporting high-cost areas, the FCC operates five separate support programs for ILECs.³⁶ Support is administered for the FCC by the Universal Service Administrative Company (USAC).

³⁴ Some states also adjusted retail rates at the same time, often upward to a "benchmark" or acceptable level.

³⁵ Wisconsin reported that access reform was the original impetus for its fund, although the basis for support distributions later changed.

³⁶ The FCC also operates two relatively minor programs called the "Safety Net" program (for carriers with large recent investments) and the "Safety Valve" program (for carriers with large investments in acquired exchanges).

Table 2 identifies the five major federal high cost programs.

Table 2. Federal High Cost Programs

Program	Year	Eligible ILECs³⁷
High Cost Loop	1984 ³⁸	Rural
Local Switching Support	1988 ³⁹	Rural
High Cost Model Support ⁴⁰	1999 ⁴¹	Non-rural
Interstate Access Support	2000 ⁴²	"Price Cap" under FCC rules
Interstate Common Line Support	2001 ⁴³	"Rate of Return" under FCC rules

Federal support can be a major revenue source for the smaller rural ILECs, enough to reduce or even eliminate the need for a state high cost program. The "High Cost Loop" (HCL) program provides support to 1,100 of the nation's 1,353 ILEC rural carriers, roughly 80%. The average payment is \$4.69 per line per month. For a minority of rural companies, HCL support is substantial: 230 carriers receive HCL support of at least \$30.00 per line per month; and 39 carriers receive support of at least \$100.00 per line per month.⁴⁴

³⁷ All five support programs generate indirect support for competitive ETCs through the Identical Support Rule.

³⁸ See FCC, *Amendment of Part 67 of the Commission's Rules and Establishment of a Joint Board*, CC Docket No. 80-286, Decision and Order, 96 FCC 2d 781 at ¶ 29 (1984).

³⁹ 47 C.F.R. § 36.125. See FCC, *MTS and WATS Market Structure, Amendment of Part 67 (New Part 36) of the Commission's Rules and Establishment of a Joint Board*, CC Docket Nos. 78-72, 80-286 and 86-297, Order on Reconsideration and Supplemental Notice of Proposed Rulemaking, 3 FCC Rcd. 5518 (1988). Effective 01/01/89

⁴⁰ The FCC sometimes calls this program "Forward Looking Support."

⁴¹ FCC, *Federal-State Joint Board on Universal Service*, CC Docket No. 96-45, Ninth Report and Order, 14 FCC Rcd. 20432 (1999) (subsequent history omitted).

⁴² See FCC, *Access Charge Reform*, CC Docket No. 96-262, Sixth Report and Order, 15 FCC Rcd. 12,962 (2000) (*CALLS* order).

⁴³ FCC, *Multi-Association Group (MAG) Plan for Regulation of Interstate Services of Non-Price Cap Incumbent Local Exchange Carriers and Interexchange Carriers*, Second Report and Order and Further Notice of Proposed Rulemaking, 16 FCC Rcd. 19613, 19667-68 (2001) (*MAG* Order).

⁴⁴ Source: USAC reports for the fourth quarter of 2009.

Federal support is less generous for so-called “non-rural” carriers such as AT&T, Verizon, or Qwest. Federal high cost support to non-rural carriers is provided under the “High Cost Model Support” program. This program provides support to carriers in only 10 states. In those ten states, the average support payment is \$2.58 per line per month.⁴⁵ The courts have repeatedly found that the FCC has failed to demonstrate the sufficiency of this support.⁴⁶

For some ILECs, federal support creates a strong financial incentive for further investment. Approximately 80% of rural ILECs have loop costs sufficiently high to receive HCL support. When a supported ILEC makes an additional investment in loop plant, 65% of the additional carrying cost is recovered as HCL support.⁴⁷ Moreover, 25% of the additional carrying cost is assigned to the interstate jurisdiction by separations.⁴⁸ In sum, when a rural ILEC already eligible for HCL support makes an additional loop investment that increases its carrying cost by \$1.00, it recovers an additional \$0.90 from federal sources.⁴⁹ Most rural carriers can therefore invest in high-quality loop facilities at a small additional monthly cost to their own local subscribers.

The incentives for non-rural ILECs are quite different. For these carriers, Model Based Support, if any, is based on costs that are produced by the FCC’s proxy model. The model, however, is uninterested in the carrier’s actual investment. An incremental investment in loop plant by a non-rural carrier has no effect on its support. This difference in incentive structures helps explain why several state commissions reported that the rural carriers in their states have deployed more broadband Internet facilities than have their non-rural carriers.

⁴⁵ *Id.*

⁴⁶ The Tenth Circuit Court of Appeals has twice remanded the High Cost Model Support program back to the FCC for further consideration. In the second decision issued in 2005, the court remanded because those rules “ensured that significant variance between rural and urban rates will continue unabated.” *Qwest Communications International Inc. v. FCC*, 398 F.3d 1222, 1237 (10th Cir. 2005). At the end of 2009, the FCC had not taken a substantive action on that order. On December 15, 2009, the FCC issued a *Further Notice of Proposed Rulemaking* (FCC 09-112) and stated that it will not be feasible for it to take actions on universal service reform before April 16, 2010.

⁴⁷ Under 47 C.F.R. § 36.631(c)(1), for small rural carriers with fewer than 200,000 lines, 65% of loop investment carrying cost above a fixed benchmark is transferred to the interstate jurisdiction. The benchmark is nominally 115% of the national average cost, although the actual benchmark has been raised because of an overall spending cap in the HCL program.

⁴⁸ See 47 C.F.R. § 36.154(c) (25% of investment in common lines assigned to interstate).

⁴⁹ For a carrier with fewer than 200,000 lines and costs above the second benchmark, the expense transfer is 75% or cost rather than 65%. Therefore the total interstate allocation of incremental cost is 100%. 47 C.F.R. § 36.631(c)(2).

Gradual erosion of federal support creates a business risk for ILECs serving high-cost areas. For example, the HCL program operates under a fund size cap. That cap effectively moves support from one carrier to another over the course of time. Even an ILEC that has constant costs can find that its HCL support decreases over time if other ILECs receiving HCL support have increasing costs.

Policy revision is a second risk. Federal universal service programs have proven quite durable, but they are under frequent criticism. The FCC or Congress might make dramatic revisions to these programs that could generate a need for a state high cost fund.

In sum, a state considering establishing a high cost program should evaluate the sufficiency of federal high cost support. In some states, rural areas are served by small rural carriers and federal support obviates the need for a state high cost program. In other states the high-cost regions are served by a non-rural carrier and federal support is likely to be minimal or nonexistent. State commissions should also remain aware of trends in ILEC support, if only to anticipate a future demand that state funds should replace losses in federal support.

C. The distribution of cost

How costs fall within a state must be a principal consideration in whether that state needs a high cost fund. On a per-customer basis, urban costs are usually lower than rural costs. The typical urban customer is served by a relatively short "loop" of telephone wire and by large central offices with low average cost. Conversely, a typical rural customer may be served by a long loop and a small switch that is located scores of miles from the main toll network. The cost per line can be many times higher in a rural area.

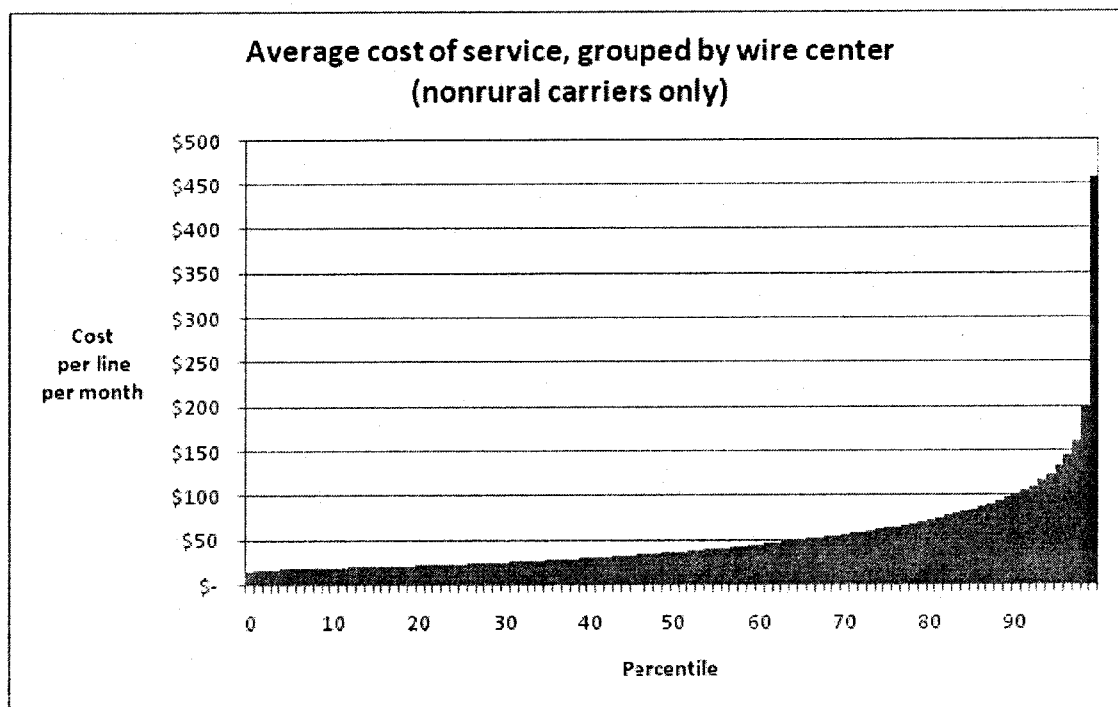
1. Costs at the wire center level

While most regulators intuitively understand that costs are higher in rural areas, it is more difficult to appreciate the scale of those differences. Fortunately, computerized cost models can help. During the 1990s, the FCC developed a computerized model to estimate the cost of constructing a new telephone network. The FCC often calls this its "proxy" cost model because the program virtually constructs a network as a proxy for the real network.⁵⁰ The proxy model

⁵⁰ The FCC has explained that proxy models typically are designed to answer the following question: "If a single carrier were to build an efficient network today to serve all customer locations within a particular geographic area, taking as given only the locations of existing [ILEC central offices], how much would it cost to construct and maintain the network?" FCC, *Review of the Commission's Rules Regarding the Pricing of Unbundled Network Elements and the Resale of Service by Incumbent Local Exchange Carriers*, WC Docket No. 03-173, FCC 03-224 (*UNE Pricing NOPR*) π 49.

estimated the monthly costs per line for each of the 12,499 wire center areas⁵¹ operated by large “non-rural” carriers throughout the United States. Chart 1 displays that cost distribution.

Chart 1. Forward-looking Cost, Averaged by Wire Center Area, by Percentile (Non-rural Carriers Only)



Source: FCC proxy model outputs for 2000, authors' calculations.

Chart 1 illustrates why cost is so important in evaluating the need for a state fund.

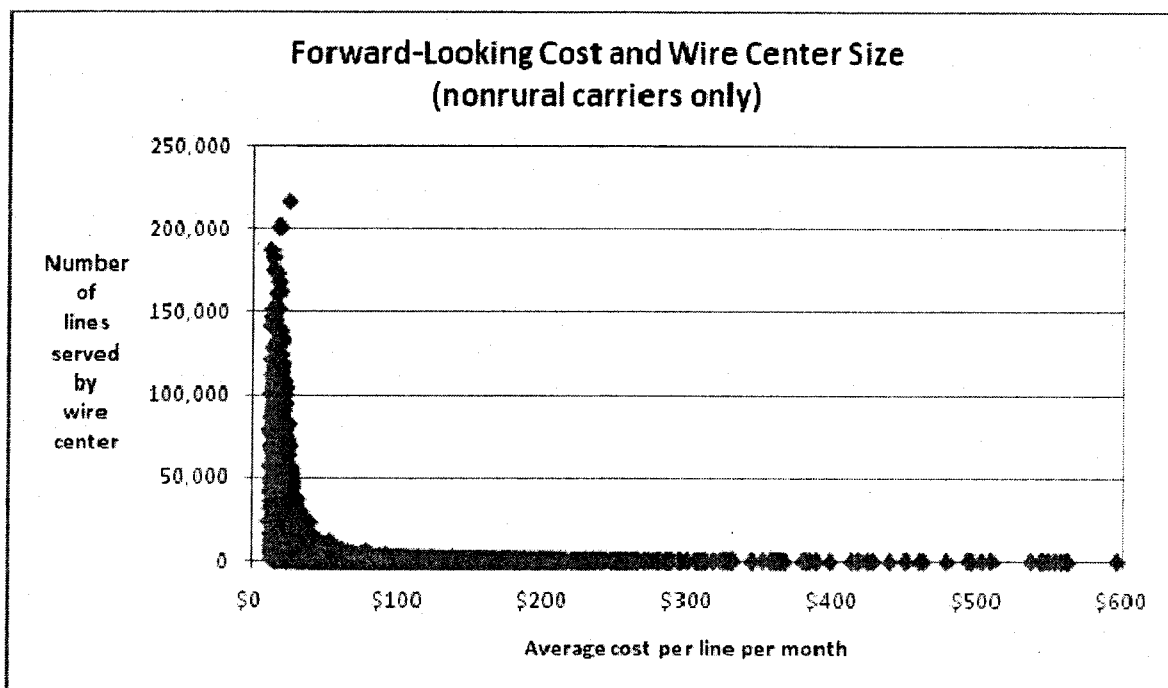
1. Most wire centers have above-average costs. The national average cost of \$23.36 occurs in the 25th percentile of wire centers. This means that for every wire center with below-average cost, there are approximately three with above-average cost.
2. Many wire centers have high costs. The \$50 cost barrier is crossed at the 65th percentile. The \$100 cost barrier is crossed at the 90th percentile. Revenues to cover such costs usually require local rates at a level that most states would consider unaffordable.

⁵¹ “Wire center area” here describes the area served from a single ILEC “central office.” The area is also sometimes called an “exchange” area or a “central office” area.

3. A few wire center areas have extraordinarily high costs. The 99th percentile group has an average cost of over \$457 per line per month. This is far in excess of the revenues available to an ILEC charging affordable local rates.

The FCC proxy model results also show that population density is a strong predictor of cost. Chart 2 shows the relationship between wire center size and cost for all 12,499 wire center areas.

Chart 2. Relationship of Wire Center Area Size and Cost



Source: FCC proxy model outputs for 2000, authors' calculations.

Chart 2 shows that nearly all large wire center areas have relatively low costs. Conversely, nearly all wire center areas with high costs serve few customers. The most costly 1,000 wire center areas have an average size of 416 lines, a size characteristic of very rural areas or very small towns.

Wire center size is itself a good proxy for population density. Most small wire centers typically are found in rural areas. Conversely, most large wire centers are found in urban areas. Chart 2 therefore argues that low-density areas generally have high costs, in many cases very high costs.⁵²

The distribution of costs among customers is quite unlike wire centers. If three quarters of *wire centers* have above-average cost, it is equally true that three quarters of *customers* have below-average costs. The average cost in the FCC national data set was \$23.35 per line per month. 74% of the lines had a cost below that average. 95% of the lines had costs below \$40 per month.⁵³

2. Small area cost differences

The FCC proxy cost data treat costs as though they were uniform within each wire center. In actuality, costs often vary a great deal within a single wire center. This phenomenon has been described metaphorically as the “donut” and “hole” problem. The donut is the area at the periphery where loops are long and costs are high. The hole is the area adjacent to the wire center building where loops are short and costs are low. If these intra-wire center cost variations are considered, the cost differences among customers becomes even wider than is suggested by the proxy models.

Today, these small-scale cost differences are more economically relevant to universal service policy than they were in 1999 when the FCC designed its proxy model. Competitors today seldom serve an entire wire center area. Instead, they often avoid building facilities in the high-cost “donut” at the periphery.⁵⁴ When an ILEC’s customer in the “hole” switches to such a competitor, the ILEC’s average cost increases to serve its remaining customers. This can force the ILEC to raise its rates, possibly to unaffordable levels. Even where an ILEC does not raise its local rates, it may present a claim for high cost support in return for complying with COLR obligations in the high-cost donut at the periphery.

In sum, the cost profile within a state is an important factor in deciding whether the state needs a program. Three cases illustrate the problem.

⁵² The FCC agrees. FCC, *Matter of Federal-State Joint Board on Universal Service*, CC Docket No. 96-45, Tenth Report and Order, FCC 99-304, π 26 (1999). Although not illustrated here, costs are also influenced by geographic factors such as topography, soils, and climate.

⁵³ This apparently paradoxical result occurs because high-cost wire centers tend to serve few customers.

⁵⁴ For example, a CLEC might overbuild a few blocks of a downtown area, or a cable company might serve the more densely populated portion of an exchange area. A wireless ETC might serve a downtown area with its signal, using wireline resale for the mountainous edge of a service area.

1. A state with homogeneously low costs is unlikely to need a high cost program. In that state, customers are likely to have uniformly low rates, and service is likely to be ubiquitous without any government fiscal intervention.

2. A state with homogeneously high costs is unlikely to benefit from a high cost fund. In that state, any fund would accomplish little because all customers would have to pay a high rate to provide a meaningful benefit, and nearly all customers would receive benefits. While the amount of money raised and spent might be large, the net effect would be small.

3. A state that has some high-cost areas and some low-cost areas is most likely to need and to benefit from a high cost fund. In that state, high-cost areas can benefit from support, and the added universal service surcharge is unlikely to make monthly bills unaffordable.

D. Implicit subsidies

State commissions historically have supported low residential local rates using a variety of mechanisms. It has been common in the telecommunications industry to call these arrangements "implicit subsidies." For example, urban customers are often said to "subsidize" rural customers.

1. "Subsidies" and "support"

Economists define the term "subsidy" narrowly. An economic subsidy occurs only when one customer receives service at a rate that is below the carrier's "marginal cost." Marginal cost is defined as the additional cost of providing one additional unit of output. In telecommunications, marginal cost usually means the additional cost to an ILEC from adding a single customer to its network.⁵⁵

Within the telecommunications industry, most costs are fixed. To operate a network, an ILEC must make a large investment in poles, wires, and switches. Once that investment has been made, the marginal cost of serving an additional customer is small.⁵⁶ For this reason, true subsidies in telecommunications are rare.

⁵⁵ Marginal cost can also mean the additional cost of providing one more minute of usage, particularly toll usage.

⁵⁶ In the extreme case, a new customer has telephone wires already serving his or her location and can often be served simply by issuing a software command at the central office switch.

Assertions about “subsidies” in telecommunications often are best understood as statements about differences in *average* cost between areas or customer groups.⁵⁷ If urban customers do indeed impose lower average costs than rural customers, then state and federal regulators can legitimately consider that fact in setting rates. However, it is not generally accurate to describe this arrangement as a “subsidy.” It would be accurate to say that the urban customer makes a larger contribution to fixed costs than the rural customer. Or, one might say that the urban customer provides “implicit support” to rural customers.

2. The “big three” support flows

The FCC used the term “subsidy” in the less precise way in 1997, soon after TA96 was enacted. The FCC defined subsidy as an occasion where “a single company is expected to obtain revenues from sources at levels above cost (i.e., above competitive price levels) and to price other services allegedly below cost.”⁵⁸ The FCC found that universal service had been achieved largely through three kinds of subsidy.⁵⁹

- 1, The urban-to-rural subsidy. ILECs that serve rural areas tend to have high average costs because their rural customers require longer wires and more utility poles. In addition, rural switches tend to be smaller and cost more per customer served. Despite these widespread cost differences, rates have not matched costs. Local exchange rates in rural areas generally are the same as urban rates. In some areas, “value of service” pricing produced lower rural rates.⁶⁰
2. The toll-to-local subsidy. ILECs often also impose high access charge rates when the ILECs provide origination or termination services to IXCs. The marginal cost to the ILEC of providing this service is often far lower than the access rate.

⁵⁷ In economics, the “average cost” of a business enterprise is the sum of all its fixed and variable costs divided by its total output.

⁵⁸ FCC, *Federal-State Board on Universal Service*, CC Docket No. 96-45, Report and Order, 12 FCC Rcd. 8776, π 10, note 15 (1997) (*First USF Order*) (internal quotations omitted).

⁵⁹ *Id.*, π 10. The FCC also briefly mentioned higher rates for “vertical features” as a mechanism that keeps local rates low. *Id.* π 14.

⁶⁰ The value-of-service principle adjusts rates based on the number of telephone numbers that a subscriber can reach without incurring toll charges. In an urban area, customers pay higher rates because they can make local calls to hundreds of thousands of lines, or even millions. In a sparsely populated rural area, rates are lower because local calls can reach only a small number of lines. The rural value-of-service was lower because a call to reach community services such as schools and doctors was often likely to be an expensive toll call.

3. The business-to-residential subsidy. ILEC business rates are almost universally higher than residential rates, yet the underlying cost of providing service to these customers is approximately equal.

The FCC went on to announce a goal for its own universal service programs, as well as state programs. The goal was to replace these implicit subsidies with explicit subsidies paid through state and federal high cost programs.⁶¹

At least initially, the courts seemed to approve of the FCC's statutory interpretation of state duties.⁶² Later courts, however, clarified that federal law does not require states to eliminate all existing implicit subsidies. Congress did not "expressly foreclose the possibility of the continued existence of state implicit support mechanisms that function effectively to preserve and advance universal service."⁶³

Even if federal law does not mandate that states eliminate implicit subsidies, many states have chosen to do so, for economic and policy reasons of their own. Many existing state high cost funds were created incidental to actions that reduced the toll-to-local "subsidy" (or in a few cases the urban-to-rural "subsidy"). Several state commissions today are considering whether to take similar steps.

3. Urban-to-rural support flows

Of the three kinds of implicit support identified by the FCC, the urban-to-rural transfer presents the greatest challenge to state commissions. One reason is the declining size of the other two support flows. The toll-to-local support flow has decreased as the FCC (and many states) lowered access and toll rates in the years following 1996. The FCC enacted notable reductions in interstate access rates in 2000 and 2001. The business-to-residential support flow has also decreased as larger business customers have increasingly shifted their

⁶¹ *First USF Order*, ¶ 14 ("States, acting pursuant to sections 254(f) and 253 of the Communications Act, must in the first instance be responsible for identifying intrastate implicit universal service support. We further believe that, as competition develops, the marketplace itself will identify intrastate implicit universal service support, and that states will be compelled by those marketplace forces to move that support to explicit, sustainable mechanisms consistent with section 254(f)."). One federal court went so far as to state that TA96 "does not permit the FCC to maintain *any* implicit subsidies for universal service support."

⁶² *Texas Of'c of Public Utility Counsel v. FCC*, 183 F.3d 393, 425 (5th Cir. 1999) (plain language of statute "does not permit the FCC to maintain *any* implicit subsidies for universal service support") (emphasis in original); *Texas Of'c of Public Utility Counsel v. FCC*, 265 F.3d 313, 318 (5th Cir. 2001) ("The 1996 Act thus required that the implicit subsidy system of rate manipulation be replaced with explicit subsidies for universal service.")

⁶³ *Qwest Communications Int'l. Inc. v. FCC*, 398 F.3d 1222, 1233 (10th Circuit 2005).

telecommunications to "Centrex" and unswitched services and as ILECs developed competitive new bundles of services for business customers.

The urban-to-rural support flow challenges state commissions because different industry groups have such divergent views.

- To ILECs, the problem lies in urban areas. The urban-to-rural implicit support flow raises the ILEC's rates in urban areas. This creates an advantage for competitors who have no comparable burden to support rural areas. Some ILECs advocate making this support flow explicit because an explicit fund can spread the financial burden equally to all local exchange competitors. ILECs have nevertheless been cautious in recommending high cost programs. In some states, the ILECs have advocated for explicit funds only after they suffered substantial line losses.
- To competitors, the universal service problem, if any, lies in rural areas. Where ILECs receive support for rural customers, a facilities-based competitor can find it economically impossible to match the incumbent's subsidized price. Even where a new entrant has a less costly technology, the universal service subsidy can offset that advantage. For these reasons, competitors are generally reluctant to support high cost programs under any circumstances. Where such programs do exist, competitors often focus their advocacy on gaining the right to receive support payments in amounts equal to the ILEC.

Federal universal service support also complicates the analysis of the urban-to-rural support flow. Federal support varies greatly from one geographic area to another, even where costs are similar. Federal support to rural ILECs has been generous, allowing some rural ILECs to set low local rates. Where local rates are low, the urban-to-rural support flow is small and competitive effects are proportionally weaker. By contrast, many equally costly areas served by larger companies receive no federal support for intrastate costs. It is a complex task for state commissions to sort out how these support differences affect competition, universal service goals, and the need for a state high cost fund.

The main barrier to making the urban-to-rural support flow explicit is insufficient financial resources. Depending on how the task is defined, the implicit support flow can be larger than the funding levels practically available to a state high cost fund. The size of the task depends critically on the scale at which the state chooses to look at costs.

Historically, cost data have always been averaged at some scale. All cost-based support mechanisms therefore reflect a scale decision. Federal programs created before 1996 operate at the "study area" level, which equates roughly to each carrier's service area in each state. The advent of proxy models made it possible to estimate costs at the wire center level, and even below that level. The FCC's program for non-rural ILECs, the Model Based Support program, uses proxy model cost data generated at the wire center level, but those costs are subsequently averaged at the state level.

When costs are averaged across a large area, low costs in one area frequently offset high costs in another area. This averaging effect drives the results toward the mean, thereby reducing the cost dispersion as well as the apparent need for support. Therefore, averaging cost over a large area reduces the apparent size of the implicit support flows. We illustrate this effect using the FCC's proxy model. For this exercise, we applied a generic cost-based support mechanism to that cost data.⁶⁴ Table 3 illustrates how changing the scale of cost averaging alters the support demand.⁶⁵

*Table 3. Effect of Cost Averaging Scale on Support Demand
(U.S. non-rural company areas)*

Cost Averaging Scale	Total Cost of Service (billions)	Switched Lines (millions)	Support Parameters	Supported Lines (millions)	Fund Size (millions)
State	\$45.5	162.6	\$30.00 / 100%	7.6	\$416
Study area	\$45.5	162.6	\$30.00 / 100%	15.4	\$1,300
Wire center	\$45.5	162.6	\$30.00 / 100%	19.5	\$3,686

The last two columns of Table 3 show that, assuming constant support parameters, at finer scales of cost averaging, the number of supported lines and the fund size both increase. In this illustration, averaging cost at the wire center level costs almost ten times as much as calculating costs at the state level.⁶⁶

Cost patterns within individual states vary from this illustration. Also, a state might replace only a portion of the implicit urban-to-rural support flow or it might use a higher benchmark for support eligibility. Nevertheless, the example illustrates why it is financially difficult to replace all implicit support with explicit support. If one seeks to make all of the urban-to-rural support flow explicit, one must measure cost at a fine scale, and the resulting financial demand can be dauntingly large.

⁶⁴ We set the cost "benchmark" (threshold for support) at \$30.00 per line per month, which is 128% of average cost in that data set. Support is calculated as equal to 100% of any excess of cost over that benchmark. The benchmark used here is approximately equal to the benchmark currently used by the FCC's High Cost Model Support program (\$28.13).

⁶⁵ Source: FCC public cost data for 2000, (available at <http://www.fcc.gov/wcb/tapd/hcpm/welcome.html> - "wirecenter support spreadsheet"), author's calculations.

⁶⁶ The FCC's proxy cost data did not permit us to take the last step, measuring cost differences below the wire center level. This additional step is necessary to eliminate implicit support flows from "holes" to "donuts."

IV. Eligible Recipients

A threshold task for any high cost program is to define which carriers will receive or benefit from support, and what will be required of them. Some states answer this question using carrier classifications. Other states use a designation process that measures the individual characteristics or capabilities of the carriers.

A. Qualifying by classification

Some states provide support for some carriers and deny it to others, based upon classifications of those carriers, either by function or by technology. Often these classifications are made by statute. Among states that qualify by class, the overall pattern is to provide most or all support to ILECs, often solely to rural ILECs.

- Idaho and Illinois law limits support to rural ILECs.
- Nevada provides support only to carriers of last resort.
- Oklahoma's OUSF and HCF payments are available only to rural ILECs.⁶⁷
- Pennsylvania limits support solely to ILECs, but excludes Verizon Pennsylvania and Verizon North.⁶⁸
- South Carolina provides support only to ILECs that are COLRs.

Some states exclude one or more classes of carriers from eligibility. California, Wisconsin, and Oregon make wireless carriers ineligible.

B. Qualifying by designation

Some states provide support only to carriers that have individually been found qualified. Following terminology and practice from federal law, these states often "designate" the carriers eligible for state support by issuing an order based on findings about the carriers' capabilities, policies, and practices.

1. The federal list of supported services

Federal law has been a template for many state designation decisions.⁶⁹

⁶⁷ Oklahoma makes support for Internet connections and schools and libraries available more broadly.

⁶⁸ Pa. Code tit. 52 § 63.162.

⁶⁹ Alaska, California, Illinois, Pennsylvania, South Carolina, and Wyoming determine eligibility for state support on some basis other than federal ETC designation.

- Colorado, Indiana, Nevada, Oklahoma, Oregon, and Wisconsin use federal ETC designation as the sole qualification for state support.
- Arkansas, Idaho, Kansas, Nebraska, New Mexico, and Utah require federal ETC designation, but that alone is not sufficient to establish eligibility for state support.

Under federal law, a carrier must be designated as an Eligible Telecommunications Carrier (ETC) before it becomes eligible for federal high cost support.⁷⁰ States are authorized under federal law to conduct these federal designation proceedings. Most states accept this delegation of federal authority, holding these hearings whenever a carrier seeks a federal designation.⁷¹

To qualify as a federal ETC, a carrier must show that it offers a list of "services" throughout its service areas and advertises the availability of those services.⁷² The FCC has defined a list of "supported services" that contains nine elements:⁷³

1. Voice-grade access to the public switched network, with the ability to place and receive calls;
2. Local usage;
3. Dual-tone multi-frequency signaling or its functional equivalent;
4. Single-party service;
5. Access to emergency services, including, in some instances, access to 911 and enhanced 911 services;
6. Access to operator services;
7. Access to interexchange services;
8. Access to directory assistance; and
9. Toll limitation services for qualifying low-income consumers.

This list has been widely used by the states, but it has some limitations. First, the list does not describe "services" in the usual sense of a benefit that can be purchased separately, like dry cleaning and a haircut. Rather, the federal list describes the benefits that can be purchased only as a component of basic local exchange service.

Some of the federal elements are already required by law, at least from ILECs. For example, all ILECs must provide access to emergency services, even to customers who, for whatever reason, might not want to pay for them. Similarly, many states have eliminated "party

⁷⁰ 47 U.S.C. § 214 (e)(2). Following federal practice, many states also call the carriers eligible for state high cost support "Eligible Telecommunications Carriers."

⁷¹ Virginia is one state that does not hold designation hearings. A few states decline to hold hearings for wireless carriers.

⁷² See generally, 47 U.S.C. § 214(e).

⁷³ 47 C.F.R. § 54.101(a).

line" service⁷⁴, thereby effectively making single-party service a mandatory feature of local service.⁷⁵

One element in the federal list has never been defined. In 1997 the FCC promised to prescribe by the end of that year how many minutes of flat-rated local usage service would be required to be included within local usage.⁷⁶ The FCC has never made that decision. When two wireless carriers sought designation at the FCC in 2004, the commission sidestepped the requirement, accepting assertions that the carriers would in the future comply if the FCC should ever define the requirement.⁷⁷ Therefore, the federal local usage requirement can be meaningless, at least in relation to mobile service providers.

2. Three uses for supported service lists

Many states have adopted a version of the federal list of nine services to qualify carriers for eligibility. In practice, such lists have produced effects of other kinds.

For the most part, high cost funding is not used directly to provide retail services. Rather, it is used to construct and maintain network facilities and to support company functions such as customer service. A high cost program administrator therefore must translate any list of services into operational decisions about facilities. One decision category is how the list should affect the measurement of cost and the calculation of support. Another decision category is how the list should constrain the carrier's use of support. A list of supported services therefore can answer three different questions, as shown in Table 4.

⁷⁴ Party line service used a single loop for multiple customers, each of whom had a distinctive ring.

⁷⁵ Even if the federal list describes components of basic exchange service, one such component is optional, at least in some states. Touch-tone dialing is an optional feature in some areas and generates a separate monthly charge.

⁷⁶ *USF First Report and Order*, π 67.

⁷⁷ FCC, *Federal-State Joint Board on Universal Service; Highland Cellular, Inc. Petition for Designation as an Eligible Telecommunications Carrier for the Commonwealth of Virginia*, CC Docket No. 96-45, Memorandum Opinion and Order, π 15, 19 FCC Rcd. 6422 (2004) ("*Highland Cellular*"); FCC, *Virginia Cellular, LLC Petition for Designation as an Eligible Telecommunications Carrier for the Commonwealth of Virginia*, CC Docket No. 96-45, Memorandum Opinion and Order, π 14, 19 FCC Rcd. 1563 (2004) ("*Virginia Cellular*").

Table 4. Three Applications for a Supported Services List

No.	Application	Question
1.	Designation	What services or facilities must a carrier provide to qualify for universal service support?
2.	Support amount	When the state calculates support for the carrier, what service or facility costs should be included?
3.	Use of funds	When a carrier receives state support, to which services or facilities must it apply that support?

A single list that provides the same answer to all three questions can create unexpected problems with new services. Those problems can be illustrated using broadband facilities.

- A state with an embedded cost support mechanism might want to allow carriers to report costs for some expenditures that support broadband facilities and to receive support on those costs (#2). At the same time, the state might not want to disqualify all carriers that do not yet provide ubiquitous broadband service (#1).
- A state might want to allow a carrier to use support to construct facilities that support voice and broadband services in common, such as high-capacity feeder networks (#3). At the same time, the state might use a proxy cost model for support but not want to redesign that model to assume that broadband facilities have been built (#2).

Federal support programs have historically experienced some of these same kinds of problems.

- The federal list does not yet include broadband. Nevertheless, many rural carriers today receive federal support for broadband-supporting facilities (#2),⁷⁸ and they have been allowed to use federal support to construct such facilities (#3).⁷⁹

⁷⁸ Rural carriers receive federal High Cost Loop (HCL) support based on their net loop investment per line. Whether a particular investment qualifies as loop investment is determined by the FCC's accounting and separations rules. See 47 C.F.R. §§ 36.621, 36.631. The rules do not identify the carrier's motive for a loop investment. Therefore, a rural carrier receiving High Cost Loop Support can increase its loop investment in ways that enhance broadband service, it can report that investment for HCL support purposes, and HCL support will increase in subsequent years.

⁷⁹ Carriers can use HCL support to make broadband investments so long as the state commission annually certifies that the carrier is properly using federal support. Subsection

- In 2003, the FCC considered adding broadband to the federal list in order to promote broadband spending by carriers (#3). The FCC rejected this proposal, in part because adding broadband would increase the demand for support (#2).⁸⁰ Also, the FCC found that adding broadband to the list would disqualify carriers that were not then providing broadband ubiquitously to all their customers (# 1).⁸¹

It should be noted that not all states impose limitations on carriers' use of high cost funds. While some state policies limit support uses to a specific list of services, other states simply support the carrier's total operations. This tends to be the case for states that qualify support recipients by classification. For example, a state that has designed its high cost fund to maintain rural ILEC rates of return at a specified level would take the less restrictive approach regarding the use of funds. Oregon's high cost fund, for example, takes this approach.

In sum, a state that adopts a supported services list should anticipate the ways in which that list will be applied. Recognizing that such a list has varying applicability in different applications can increase the state's future ability to suitably respond to emerging services.

3. The 2005 federal designation requirements

In 2005 the FCC issued a Report and Order that expanded the recommended list of requirements for federal ETC designation and also expanded requirements for the annual certifications required of designated carriers.⁸² Most states report they have followed the FCC's suggestions, whether or not they have their own high cost funds.⁸³

- The FCC suggests that states require the applicant to commit to provide service throughout the proposed designated service area to all customers making a

254(e) of federal law requires that federal high cost support be used "*only* for the provision, maintenance, and upgrading of facilities and services for which the support is intended." 47 U.S.C. § 254(e) (emphasis added). To implement this statute, the FCC requires state commissions annually to certify that ETCs in their states meet this standard. 47 C.F.R. §§ 54.313, 54.314.

⁸⁰ FCC *Federal-State Joint Board on Universal Service*, CC Docket No. 96-45, Order and Order on Reconsideration, FCC 03-170, 18 FCC Rcd. 15,090 (2003) (*Supported Services Order*) π 11.

⁸¹ *Supported Services Order*, π 12. See also, *Federal-State Joint Board on Universal Service*, CC Docket No. 96-45, Recommended Decision, released July 10, 2002, Separate Statement by Commissioner Bob Rowe.

⁸² FCC, *Federal-State Joint Board on Universal Service*, CC Docket No. 96-45, Report and Order, FCC 05-46, 20 FCC Rcd. 6371 (2005).

⁸³ States that do not have their own funds generally apply these standards as conditions of federal ETC status.

reasonable request for service. Many states require the wireless ETC applicants to provide coverage maps in addition to a description of the proposed service areas.⁸⁴

- The FCC suggests that states ask each carrier for a five-year plan for network improvements.
 - Most of the states with high cost funds reported that they do require a network improvement plan. Arkansas and Utah do not.
 - Seven of the states without a high cost fund reported that they do not ask for a network improvement plan (Alabama, Kentucky, Maryland, Mississippi, North Carolina, New Hampshire, and Tennessee).
 - Several states ask for a plan covering fewer than five years. Wyoming asks for a three-year plan. Colorado, Idaho, Kansas, Maine, and South Carolina ask for a two-year plan. Washington asks for a one-year plan.
- The FCC suggests that states require ETCs to verify that they can remain functional in an emergency. Virtually all of the states, with or without a high cost fund, ask carriers to certify emergency readiness.⁸⁵
- The FCC suggests that states require ETCs to affirm that they can satisfy customer protection and state service quality rules. Virtually all states, with or without a high cost fund, require ETCs to meet service quality and consumer protection requirements.⁸⁶
- The FCC suggests that states require ETCs to provide a local usage plan comparable to that of an ILEC. Most of the states require a local usage plan.⁸⁷ Alaska requires that plan to provide at least 500 free minutes of usage per month.
- The FCC suggests that states require ETCs to provide customers with equal access to long distance carriers.⁸⁸ Most states require applicants to demonstrate a commitment to fulfill equal access requirements.⁸⁹

⁸⁴ For example, in Washington, a wireless ETC applicant is required to file the network coverage map in the initial petition and every three years thereafter.

⁸⁵ Maryland and New Hampshire are exceptions.

⁸⁶ New Hampshire was the sole exception among states without high cost funds.

⁸⁷ Tennessee and the Virgin Islands are exceptions.

4. State-ETC designations and additional requirements

States do not always differentiate clearly among requirements that are imposed on carriers of last resort (a traditional common law category),⁹⁰ on federal ETCs designated by the state commission (carriers eligible for federal support), and on state ETCs (carriers eligible or state support). A few states do make such an explicit distinction, at least as between federal ETCs and state ETCs.

- Texas has defined the category of “Eligible Telecommunications Provider.” Only Texas ETPs receive state support.
- Idaho has also clearly established state ETCs as a distinct category.

Regardless of terminology, states often establish additional requirements for carriers that are eligible for state support.⁹¹ Some of these requirements elaborate on similar FCC standards.

- Nebraska requires supported carriers to provide the customer with a white pages or alphabetical directory listing.
- Texas requires competitive ETCs to offer flat-rated unlimited local calling services at a rate no higher than 150 percent of the ILECs’ state average rate.
- Washington (which does not have a high cost fund) requires wireless federal ETCs to submit network maps every three years.
- Missouri (which does not have a high cost fund) requires each federal ETC to make a commitment to extend its network to serve new customers upon a reasonable request and requires wireless providers to provide the commission with an informational filing describing all the carrier’s service offerings.

In other cases, the supplemental state requirements have no current federal analogue.

- Texas requires data transmission at 14.4 kbps, a rate that is not usually considered “broadband” speed and that can be achieved using analog modems on standard switched circuits.⁹²

⁸⁸ “Equal access” is the industry term for direct dialing a toll call with a “1” prefix that connects the caller to an interexchange network.

⁸⁹ Alaska, Kansas, Idaho, and Washington do not require equal access.

⁹⁰ See also, Bluhm and Bernt, *Carriers of Last Resort: Updating a Traditional Doctrine* NRRI Report 09-10 (2009) at 5-7 (common duties assigned to carriers of last resort).

⁹¹ As noted above, Arkansas, Idaho, Kansas, Nebraska, New Mexico, and Utah reported that they require ETC designation as a prerequisite to state support, but that such a designation is not sufficient.

- Wisconsin and a few other states require supported carriers to provide Public Interest Pay Telephones.⁹³
- New Mexico requires carriers to provide an 800 number for customer complaints.
- Alaska and Washington (which do not have high cost funds) require wireless ETCs to meet power backup standards.

At least one state has eliminated an element in the FCC's list: Wyoming does not require single-party service or toll limitation to qualify for state support.

Historically, state high cost programs have sought to support only voice telephone service. Nevertheless, many states have taken other kinds of measures to promote broadband. Many states leave carriers free to use state high cost funding for any corporate purpose, including constructing broadband facilities. Also, many states use merger approval proceedings and alternative forms of rate regulation proceedings as opportunities to impose broadband build-out requirements. Some states also provide broadband construction subsidies to institutional users such as schools, libraries, and rural health care facilities.

More recently, some states have begun to establish separate universal service-like programs for broadband service. Recent congressional bills⁹⁴ and FCC deliberations⁹⁵ have also increased state interest in promoting broadband. Nine states reported to us that they have a state program to support advanced telecommunications services or broadband, although not all broadband programs are administered by the state utilities commission.

At least one state has established broadband capability as a prerequisite to eligibility for state high cost funds.

- In 2009, the Wisconsin commission established a new requirement that supported carriers must provide data transmission at a minimum rate of 250 kbps upstream and 750 kbps downstream.⁹⁶ This is a common speed for "ADSL" service on telephone networks.

⁹² Tex. Admin. Code, tit. 16, part 2, § 26.54(b).

⁹³ Wis. Admin. Code, PSC 160

⁹⁴ See, e.g., "Discussion Draft" legislation released by Congressman Boucher and Congressman Terry on November 6, 2009.

⁹⁵ The FCC is required by federal law to issue a National Broadband Plan in February of 2010.

⁹⁶ Wis. Admin. Code, PSC 160.031 (2009).

5. Designation of non-ILECs

Several states reported that they are willing to provide state support to non-ILECs.

- Colorado, Kansas, Utah, and Wyoming report that support is available to all ILECs, landline CLECs, and wireless carriers.
- California reports that it provides support to CLECs, but only if they are also carriers of last resort (COLRs).
- Kansas and Wyoming report that they are willing to provide support to fixed VoIP carriers such as cable voice providers.

Several states allow designation of non-ILECs, but in most of these states some other requirement or understanding tends to deter applications. The net effect often is to limit support entirely or mostly to ILECs.

- Arkansas allows any carrier to apply for funding, but only ILECs have been declared eligible.
- Indiana supports rural ILECs, but it allows any ETC to file a petition to receive support. No such petitions have been filed.
- Maine has a cost-based support program. Any new entrant seeking support from the Maine high cost fund would have to undergo a rate case using traditional rate-of-return methods. No CLEC has elected to do so.
- Nebraska's policy is to provide support to only one network in a given area. No Nebraska wireless carriers have applied for that support. If a wireless provider were to apply, it would be required to demonstrate an ability to replace the entire wireline network for that area. As a result, most Nebraska high cost fund support goes to the ILECs who provide service in high-cost areas.
- New Mexico has a hold-harmless type fund. A competitive carrier could petition for support, but none has petitioned to date. Since support is based on 2004 data, it could be difficult for a competitive carrier to apply for support.

A final question regarding support for competitive carriers is whether they should be required to have facilities. Competitors in general have fewer facilities than incumbents, and some have none at all. One approach to these differences is to use eligibility rules to require at least a minimum quantity of facilities. Federal law takes this approach and nominally disqualifies carriers with no facilities.⁹⁷ Nevertheless, the FCC has interpreted the statutory phrase "own facilities" to include facilities rented from other carriers as unbundled network

⁹⁷ To become a federal ETC, a carrier must own at least some facilities, although it can also use facilities or a combination of its own facilities and resale of another carrier's services. 47 U.S.C. § 214(e); 47 C.F.R. § 54.202(d)(1).

elements (UNEs).⁹⁸ Therefore, a carrier that relies entirely on other carrier's facilities, obtained through UNEs and resale, can indeed qualify as a federal ETC.

Any state that designates a state ETC and that requires the ETC to provide service through a combination of its own facilities and UNE or resale arrangements should consider imposing specific requirements on the designee. For example, the state might require that the ETC provide an investment plan and might also require that the ETC demonstrate that it is using the high cost support for its intended purpose, especially if that purpose is a facilities-based network expansion.

⁹⁸ 47 C.F.R. § 54.202(f).

V. Fund Distribution

The twenty-one states with high cost funds tend to distribute support using one of four modes.⁹⁹ Each mode serves different purposes and presents different challenges. This section describes and evaluates those four modes, citing examples from selected states.

A. Hold-harmless mode

The hold-harmless mode is normally adopted in conjunction with a regulatory change that reduces carrier revenue. Hold-harmless support focuses on minimizing the effects of regulatory change, often leaving the carrier in the same or nearly the same revenue position after the change.

Two types of regulatory changes affecting ILEC revenue have triggered the creation of hold-harmless state funds. Most commonly, the state decided to lower the rates for intrastate access charges paid by IXC's. Occasionally, a hold-harmless fund has been created because regulators made a rule change that reduced a rate-regulated carrier's revenue requirement.¹⁰⁰

1. The hold-harmless calculation

Computing hold-harmless support involves a calculation of the following form:

$$\text{Support} = \text{Past Revenue} - \text{Future Revenue} + \text{Adjustments}$$

The first term, *Past Revenue*, is the carrier's base or pre-change revenue that the high cost fund seeks to protect. The second term is *Future Revenue*, which is what the carrier expects to receive after the regulatory change has taken effect.

⁹⁹ At least one state has a program that falls outside these four categories. For example, Alaska's DEM weighting program, while aimed at goals similar to those of the cost-based mode, has a unique mechanism unlike that of any other state.

¹⁰⁰ The federal Local Switching Support program originated in a revenue requirement change. In 1987 the FCC adopted new separations rules that adopted a new allocator for switching and consolidated several categories of Central Office Equipment. Because the Federal-State Joint Board on Separations had been concerned about the revenue effects on small carriers, the FCC adopted the Joint Board's recommendation and created the "DEM Weighting" program, which reduced the losses of many smaller carriers. Today that program has transformed into the Local Switching Support program. See 47 C.F.R. § 54.301; *MTS and WATS Market Structure, Amendments of Part 67 (New Part 36) of the Commission's Rules and Establishment of a Federal-State Joint Board*, CC Docket Nos. 78-72, 80-286 and 86-297, Report and Order, 2 FCC Rcd. 2639 (1987).

The third term, *Adjustments*, can be put to a variety of uses. One common adjustment involves allowing a local rate increase. Several states have used an adjustment to avoid paying support to carriers that maintain very low local rates. This adjustment requires the state to establish a rate benchmark that it considers affordable. For example, if a carrier's local rate is \$10 per month and the state considers \$25 affordable, the *Adjustments* factor would be minus \$15 per line, thereby reducing the carrier's support by that amount. In a few states, the commission actually mandates corresponding local rate increases. In most states, the commission simply deems the additional revenue to have been received, regardless of whether the carrier actually raises rates to the benchmark.

2. Examples of hold-harmless state funds

Hold-harmless calculations are used in several states.

- Oklahoma has two funds, the Oklahoma High Cost Fund (OHCF) and the Oklahoma Universal Service Fund (OUSF). Each fund has a hold-harmless component.¹⁰¹
- New Mexico lowered intrastate access rates in 2006. Each carrier's support is equal to the per-minute reduction from that 2006 intrastate access reduction, multiplied by the carrier's 2004 intrastate access minutes.¹⁰² New Mexico thus declines to replace access revenues lost due to post-2004 losses of access minutes. New Mexico also uses a local rate benchmark, which was set at Qwest's local rate plus the amount of Qwest's state Subscriber Line Charge (SLC), to reduce the amount of support by the amount of revenue the carrier could realize by raising its local rates to the benchmark.
- Pennsylvania also calculates high cost fund support using a hold-harmless mechanism with a minimum local rate feature. Rural ILECs receive support limited by the revenue lost during one episode of access rate reductions. Support is also reduced by any revenue gain that would occur by raising local residential rates to a statewide affordability benchmark. The benchmark was initially \$16.00 per month but was later raised to \$18.00.

¹⁰¹ The OHCF provides support to rural ILECs in amounts equal to those previously received from a state operated intraLATA toll pool. The OUSF has a unique provision in its "Primary Universal Service" program that allows rural ILECs to recover any future revenue loss caused by state or federal regulatory actions.

¹⁰² Qwest is a special case in New Mexico and does not receive support from the New Mexico high cost fund. Instead, Qwest makes up the access charge shortfall through a state Subscriber Line Charge.

Once a state establishes a hold-harmless support amount, it must also decide whether that support amount will be adjusted to reflect future changes in costs, revenues, or regulatory policy. One choice is to leave initial support amounts unchanged. The alternative is to adjust support to reflect changes in market behavior.

- Oklahoma's OHCF replaced revenues lost to carriers when a toll pool was dissolved. Oklahoma calculated initial support amounts when the fund was created, and has not changed them thereafter.
- South Carolina's Interim LEC Fund replaced carrier revenues lost during a revision of non-basic local service rates. Support from the fund increases if access minutes increase. Support remains constant if access minutes decrease.

B. Cost-based mode

The cost-based mode focuses on supporting the costs of providing the supported service. States typically adopt the cost-based mode when they perceive a risk of business failure by ILECs or when they perceive a risk that local rates will be driven above affordable levels. The goal is to provide support that will allow the carrier to continue operating by charging reasonable rates to consumers, but without over-earning. States sometimes distribute support using a hybrid of hold-harmless and cost-based mechanisms.

Cost-based mode support is calculated using the following basic equation:

$$\text{Support} = \text{Cost} - \text{Revenue}$$

Cost-based support is based on a comprehensive picture of the carrier's operations, including all associated costs and revenues. Cost-based support therefore adapts automatically over time to a wide range of circumstances, including changes in the carrier's number of switched access lines, changes to federal universal service support, and changes to its access revenues. Cost-based support tends to increase as the carrier's revenues decrease, especially if its costs do not decrease proportionately. This is in contrast to the hold-harmless mode, where the primary focus is usually on a single episode of regulatory action and where other events, such as loss of access lines or revenue, are not reflected.

"Separations" presents a threshold question for any cost-based support program.¹⁰³ A state can define *Cost* and *Revenue* to include all of a carrier's costs and revenues. This is sometimes called a "total company" approach. Costs in this case are sometimes called

¹⁰³ "Separations" is the process under which the costs and revenues of ILECs are divided into an interstate portion and an intrastate portion. "Interstate costs" are those costs that separations assigns to the interstate jurisdiction and upon which the FCC can calculate an interstate revenue requirement. "Intrastate costs" are those assigned to the intrastate jurisdiction and upon which state commissions can calculate an interstate revenue requirement.

“unseparated” costs. The alternative is to define *Cost* and *Revenue* to include only the carrier’s intrastate costs and revenues.¹⁰⁴ As discussed below, the choice has consequences affecting how costs are measured and which revenues are counted.

1. Cost

The first term in the support equation is *Cost*. The meaning in this context is similar to the traditional regulatory concept of “revenue requirement” or “cost of service.” Many states have curtailed “rate-of-return” regulation of retail rates. Yet the same concerns that once underlay the principles of rate-of-return regulation still apply to cost-based support mechanisms. In universal service, the state wants to subsidize only carrier costs that are just and reasonable.

Cost implicitly includes a component for return on investment and a component for expenses. The investment term requires the commission to establish a rate of return for purposes of universal service support. In several of its programs, the FCC uses 11.25% for the prescribed return on capital cost.¹⁰⁵

a. Embedded costs and forward-looking costs

A threshold question for a cost-based support program is whether to estimate *Cost* using embedded methods or using a computer proxy model. Proxy models are generally described as producing “forward-looking” costs because the models virtually construct facilities that use current technology. Several states use both methods, applying embedded cost methods for rural carriers and a proxy model for non-rural ILECs.¹⁰⁶

(1) Embedded costs

Embedded cost methods begin with expenditures recorded on the carrier’s books. *Cost* here translates roughly as “revenue requirement” in a traditional rate case. It includes one component to reimburse the carrier’s operating expenses and a second component to give the carrier an opportunity to earn a prescribed rate of return on its net plant investment.

¹⁰⁴ A state should make the same jurisdictional choice for both *Cost* and *Revenue*. Inconsistent treatment can allow a company to attain a double recovery of some of its costs, or it can leave the company with no way to recover some of its costs.

¹⁰⁵ See, e.g. FCC, *Federal-State Joint Board on Universal Service*, CC Docket No. 96-45, First Report and Order, 12 FCC Rcd. 8776, 8915, (1997) (*USF First Report and Order*) (subsequent history omitted), π 250; FCC, *Federal-State Joint Board on Universal Service*, CC Docket No. 96-45, Report and Order, FCC 05-46, March 17, 2005.

¹⁰⁶ The FCC also follows this dichotomy. Its High Cost Loop program for rural carriers is based on embedded cost. The Model Based Support program for non-rural carriers uses proxy model cost, which the FCC refers to as “forward-looking” cost.

Embedded cost systems are widely criticized for creating a perverse incentive for ILECs to spend money unnecessarily. Some states address this problem by limiting certain categories of cost. A state might decide, for example, to support only the costs associated with a subset of network facilities or services, such as loop facilities. The Arkansas fund for rural carriers limits costs in this manner. A second approach is to apply a formula-based cap on certain categories of cost. For example, the federal High Cost Loop support program has a cap on corporate operations expense that is based on industry averages.

ILECs usually keep their books at the "study area" level, which often can be the carrier's entire service area within a state.¹⁰⁷ Carriers generally do not record more finely grained data about the location of their investments and expenses. Therefore, a cost-based mechanism based on embedded cost cannot by itself generate cost outputs or support calculations below the study area level.

Embedded methods generally can provide both unseparated cost and intrastate cost data, including intrastate-only investments and expenses. Therefore a state that uses embedded cost data can approach the support problem on an intrastate-only or a total-company basis.

Although support calculations require many of the same decisions as a traditional rate case, rate cases are burdensome. Several states have found less costly ways to periodically recalculate support.

- Some states have developed simplified methods to review whether support amounts appropriately match current conditions. Colorado and Maine use simplified filing methods to calculate cost.
- Some states provide the same amount of support to carriers every year, until the amount is changed. In Utah, for example, high cost support changes are ordered only if the carrier requests a proceeding to consider increased support or if the Utah Division of Public Utilities, which administers the Utah fund, requests a proceeding on the ground that the carrier is over-earning.

California created a novel mechanism to give carriers an incentive to periodically update its support calculation. California's "A Fund" support is adjusted only after a general rate case that uses embedded costs. The carrier can initiate such a case when it wishes. However, the fund has a "waterfall" provision. After a rate case, the amount of the carrier's subsidy is fixed for three years. Thereafter, support is stepped down to zero gradually over a six-year period. This provision gives the carrier an incentive to periodically update its cost data and reestablish the proper support level.

¹⁰⁷ Some carriers have multiple study areas within a state.

(2) Forward-looking cost

The alternative to embedded costs is to use a computer-based proxy model to estimate cost. Proxy models generally produce “unseparated” cost outputs that disregard jurisdiction. Where a state commission uses such cost outputs, it should take additional steps to avoid double recovery of costs.¹⁰⁸ One option is to exclude interstate costs. This can be done by calculating an interstate cost allocation factor for each supported carrier¹⁰⁹ or by using an industry-wide rule of thumb.¹¹⁰ The alternative is to adopt an equally broad definition of *Revenues* in the support formula to reflect all the interstate revenues generated by the network.

The FCC uses a proxy model in one of its support programs, the “Forward-Looking Support” program for non-rural carriers. The FCC originally announced that it would eventually apply that model to all universal service support. That never happened. Indeed, the FCC later indicated that it had serious reservations about using proxy models. Although the story takes several pages to recount, it is instructive of the strengths and weaknesses of proxy models.

In 1997, the FCC equated proxy model outputs with “forward-looking” cost or, more simply, “economic cost.” Forward-looking cost, the FCC explained, is the “least-cost,

¹⁰⁸ The first recovery would be through normal FCC-supervised mechanisms such as the federal Subscriber Line Charge, interstate access payments, and federal universal service support aimed at interstate costs, such as the Interstate Access Support program. The second recovery would be through state universal service funds.

¹⁰⁹ The state might, for example, multiply each category of proxy model investment by the actual separations factor for that kind of investment and then sum all the interstate investments. A similar procedure might be used for expenses. Alternatively, the company’s overall separations factor might be multiplied by the proxy model’s overall cost of service. States using this method should be cautious about adopting federally imposed separations factors. The FCC froze separations in 2001. Large carriers are still using separations categories and factors based on their 2000 operations. During the freeze, the interstate revenues of many carriers have grown, even as cost allocations have remained nearly constant.

¹¹⁰ For example, the FCC’s High Cost Model Support program uniformly excludes 24% of cost calculated by the proxy model. 47 C.F.R. § 54.309(a)(4). The purpose is to exclude costs that already have been separated to the interstate jurisdiction. The FCC chose 76% as an overall network blend comprised of several components: 75% allocation of loop costs (in accordance with 47 C.F.R. § 36.154(a)), 85% allocation of port costs, 0% of LNP cost and 100% of all other model-based costs. FCC, *Federal-State Joint Board on Universal Service*, CC Docket No. 96-45, Ninth Report & Order and Eighteenth Order on Reconsideration, FCC 99-306, 14 FCC Rcd. 20,432 (1999) ¶ 63.

most-efficient [sic], and reasonable technology for providing the supported services that is currently being deployed.”¹¹¹

The FCC in 1997 saw two main advantages in using proxy model costs. First, the FCC said that forward-looking cost “best approximates the costs that would be incurred by an efficient carrier in the market,” and therefore sends “the correct signals for entry, investment, and innovation.”¹¹² In short, using the proxy model for universal service was supposed to have promoted competitive entry. As it turned out, that prediction was almost entirely wrong. The proxy model did not promote competitive entry to any significant degree, at least by facilities-based carriers.

The 1999 model turned out to be largely irrelevant to the technologies that are actually offering competitive local service. The proxy model estimates the cost of overbuilding an entire exchange using switches, remote fiber-fed platforms, and “twisted pair” copper distribution facilities. The FCC said this kind of network best approximated the cost of a new entrant. In the ensuing years only a small minority of telephone exchanges have been overbuilt using that wireline technology. The leading voice competitors today are cable VoIP providers and wireless providers, each of which uses fundamentally different technologies and incurs costs in quite different ways. Cable competitors generally face lower economic costs in areas where they already have distribution facilities and higher costs in areas without those facilities.¹¹³ Wireless companies have lower costs than wireline in many low density areas.¹¹⁴

In December of 2009 the FCC admitted that its existing model, which was developed in 1999, has become obsolete.

Not only are the model inputs out-of-date, but also the technology assumed by the model no longer reflects the least-cost, most-efficient, and reasonable technology for providing the supported services that is currently being deployed. The

¹¹¹ *USF First Report and Order*, π 250.

¹¹² *USF First Report and Order*, π 224.

¹¹³ Cable providers generally use their existing cable runs to provide telephone service in common with their television offerings. Cost therefore depends on how much network upgrading is needed to make the network capable of supporting voice as an incremental service. On the other hand, unserved areas are presumably more expensive to serve because coaxial cables are more expensive to deploy and power than traditional twisted pair networks. Of course, a different proxy model could predict these costs more accurately.

¹¹⁴ If the proxy model hasn’t promoted competitive entry in rural areas, another feature of federal support has promoted entry in some areas. The Identical Support Rule provides support to CETCs in an amount per line equal to the ILEC serving the same area. In some states where federal support payments per line are high, commissions have received multiple petitions from wireless carriers seeking designation as ETCs.

Commission's cost model essentially estimates the costs of a narrowband, circuit-switched network that provides plain old telephone service (POTS), whereas today's most efficient providers are constructing fixed or mobile networks that are capable of providing broadband as well as voice services.¹¹⁵

This admission undercuts the older claim that using the cost model to calculate high cost support promotes efficient competitive entry.

The FCC in 1997 also claimed that using proxy model costs would promote ILEC efficiency.¹¹⁶ The FCC said that basing support on model-based costs would create incentives for ILECs to cut costs.¹¹⁷ While the FCC never explained fully, the claim seems to have had three elements: 1) proxy models produce lower costs than embedded costs; 2) a support mechanism that produces lower costs generates less support; and 3) reduced support promotes efficiency. We consider these propositions in reverse order.

The third proposition is arguably true. A carrier that receives less support undoubtedly will seek to cut its costs, but that may not always be desirable. Cutting unnecessary costs is desirable and can fairly be said to improve efficiency. Costs can be cut in other, more controversial ways, however, such as deferring maintenance or eliminating customer service employees. Cost cutting can also mean postponing the construction of broadband Internet facilities.¹¹⁸

The FCC's second assumption was that a model that identifies lower costs will require less support. This proposition is often true because of the structure of the support formula for cost-based support mechanisms. In general, anything that reduces the *Cost* term in that formula will reduce support. The exception is where the same change that reduces *Cost* also reduces the *Revenue* term. As it happens, that is exactly how the FCC's Model Based Support program

¹¹⁵ FCC *High Cost Universal Service Support*, WC Docket No. 05-337, Further Notice of Proposed Rulemaking, FCC 09-112, π 23 (released Dec. 15, 2009) (internal quotation omitted).

¹¹⁶ *USF First Report and Order*, π 225.

¹¹⁷ *USF First Report and Order*, π 226.

¹¹⁸ That the FCC uses a proxy model to calculate support for non-rural carriers partly explains why several state commissions reported to us that their rural carriers (that receive federal support based on embedded cost) have deployed more broadband Internet facilities than their non-rural carriers (that receive federal support based on forward-looking cost).

works, the sole program for which the FCC uses the proxy model.¹¹⁹ Under those circumstances, a change to the system of measuring costs might decrease or increase support.

The first assumption was that proxy models can produce a lower overall cost than embedded methods. Several good reasons lie behind the FCC's conclusion.

- Proxy models avoid recognizing any investment costs that an ILEC might create by "gold plating" its network with unnecessary equipment or by incurring wasteful expenses.
- Proxy models deploy modern technologies that often are less costly than older technologies.¹²⁰
- Proxy models use optimum routing methods to locate feeder and distribution facilities.
- Proxy models are less dependent upon ILEC accounting records, thereby reducing an information asymmetry that favors the ILECs.

On the other hand, other features of models increase proxy costs above embedded costs.

- Proxy models assume recent construction and therefore assume a low or zero depreciation reserve. This overstates current cost for depreciation expense. It also overstates net investment and therefore the return needed on that investment. In real networks, carriers do not instantaneously replace all of their facilities with every improvement in technology. Much of their plant is partly depreciated. Some equipment is fully depreciated but still in service.

¹¹⁹ Under the FCC's the High Cost Model Support program, the *Revenue* term is replaced by a cost "benchmark." That benchmark is set at a cost that falls two standard deviations above the mean cost. Therefore a shift in cost methodology that reduces *Cost* is very likely to reduce *Revenue* as well.

¹²⁰ For example, modern computerized switches are cheaper than older switches, thereby reducing the perceived cost of central offices. Also, modern optical transmission technologies are cheaper than electric transmission using copper wires, thereby reducing the perceived costs of constructing interoffice transport.

- Proxy models assume current labor and materials costs, but current costs can be higher than those actually incurred in constructing legacy plant. For example, the cost of copper has increased dramatically since 1999 when the FCC last estimated that cost.¹²¹

The FCC explored the broader problems inherent in proxy models in a 2003 notice of proposed rulemaking (NOPR).¹²² The NOPR was issued outside the context of universal service, but the FCC recognized some implications for universal service as well. The NOPR stated the broad objective of making forward-looking costs “more firmly rooted in the real-world attributes of the existing network, rather than the speculative attributes of a purely hypothetical network.”¹²³ Based on that 2003 NOPR and other sources, proxy models can have the following problems, some of which tend to increase cost and others of which tend to decrease cost:

- Proxy models assume a market inhabited by a ubiquitous carrier with a very large market share.¹²⁴ The cost for such a carrier may be lower than that typical of even an extremely competitive market.
- Proxy models assume that the latest technology is deployed throughout the hypothetical network. In the real world, however, even in extremely competitive markets, firms do not instantaneously replace all of their facilities with every improvement in technology. Even the most efficient carrier’s network will reflect a mix of new and older technology at any given time.¹²⁵
- Proxy models can be insensitive to the costs imposed by geography. Early proxy models (including the FCC’s Synthesis Model) used simplified layouts for their

¹²¹ From the fall of 1999 to the summer of 2008, copper costs rose from about \$0.75 per pound to more than \$3.00, an increase of 300%. See http://futures.tradingcharts.com/hist_CP.html, consulted September 15, 2009.

¹²² FCC, *Review of the Commission’s Rules Regarding the Pricing of Unbundled Network Elements and the Resale of Service by Incumbent Local Exchange Carriers*, WC Docket No. 03-173, FCC 03-224 (*UNE Pricing NOPR*). The context of the 2003 order was the rates charged for unbundled network elements (UNEs). Soon after TA96 was enacted, the FCC had required states to use a Total Element Long Run Incremental Cost (TELRIC) pricing methodology for setting UNE Rates and the FCC encouraged states to use proxy models for that purpose

¹²³ *UNE Pricing NOPR*, π 4, 193.

¹²⁴ *Id.* π 51.

¹²⁵ *Id.* π 50.

virtual feeder and distribution networks.¹²⁶ No account was taken of constraints imposed by mountains, roads, manmade barriers or bodies of water. The model therefore tended to understate costs in mountainous areas with winding roads and rights-of-way.

- Some proxy models use unrealistically high “fill factors.” A fill factor is the percentage of the capacity of a particular facility or piece of equipment that is used on average over its life. A high fill factor reduces costs by reducing the amount of spare capacity carried by the system. Real networks are built with a fill factor that anticipates future growth. In its own proxy model, the FCC declined to consider future network demand,¹²⁷ thereby increasing the fill factor and lowering cost.
- Proxy models can simplify “structure sharing” arrangements with other public utilities. The cost of installing poles, digging trenches, and placing conduit is usually shared by the incumbent LEC with other entities, such as power companies, cable operators, or other telecommunications carriers. The more sharing that a proxy model assumes, the lower the cost to the incumbent LEC of providing the element. Proxy models generally take a simplified view of these important cost variables.
- Proxy models can simplify the financial effects of common services within the network, including special access.¹²⁸ The FCC’s cost model does properly reduce average costs when special access circuits increase within an exchange. The FCC’s model is limited, however, because it is capable only of modeling the cost of DS-1 circuits. The FCC’s model does not include any procedure for calculating the cost of higher capacity DS-3 circuits¹²⁹ which are increasingly

¹²⁶ Some more modern proxy models have corrected this problem.

¹²⁷ *Federal-State Joint Board on Universal Service*, CC Docket Nos. 96-45, 97-160, Tenth Report and Order, 14 FCC Rcd. 20156, 20301-02, 20304, paras. 341, 346 (1999) (*USF Inputs Order*), *aff’d sub nom. Qwest Corp. v. FCC*, 258 F.3d 1191 (10th Cir. 2001). *USF Inputs Order*, 14 FCC Rcd. at 20243-44, para. 199 (“[T]he fact that the industry may build distribution plant sufficient to meet demand for ten or twenty years does not necessarily suggest that these costs should be supported by the federal universal service support mechanism.”).

¹²⁸ Special access circuits are point-to-point circuits operated on the switched network.

¹²⁹ *Federal-State Joint Board on Universal Service*, CC Docket No. 96-45, Forward-Looking Mechanism for High Cost Support for Non-Rural LECs, CC Docket No. 97-160, Tenth Report and Order, FCC Rcd. 20156, note 242 (1999) (Tenth Report and Order) (subsequent history omitted).

important elements in special access sales.¹³⁰ Proxy models generally do not differentiate between networks that support DSL and those that do not.

- Proxy models can use unrealistically low return rates on investment. Competition increases an incumbent's risk, but proxy models are often run at return levels established before competition was widespread.¹³¹

Maintaining proxy models has proven a difficult task for state commissions. The models rely on dozens of cost parameters and costly geographic databases. Proper maintenance requires the commission periodically to collect new input data. It may also be necessary to modify the model itself to keep up with technical advances. No state appears to have accomplished the task of keeping a proxy model up-to-date.¹³² Over time, model results become increasingly unreliable as prices of materials and labor change, as subscribership changes, and as populations move about.

b. Cost of broadband infrastructure

Underlying every *Cost* calculation is an assumption about the extent and quality of the facilities needed to provide the required services. Broadband service often requires more costly facilities, since it generally requires higher capacity feeder and distribution facilities, replacement of some existing copper lines with fiber, and the placement of more remote terminals. A broadband-capable network will generally have a higher *Cost* than a network designed only to support voice services.¹³³

A state that operates a cost-based system must decide whether broadband costs should be included in the support mechanism. At one extreme, a state might exclude all broadband-related facilities and costs, limiting *Cost* only to network costs necessary to provide voice service. One

¹³⁰ See P. Bluhm and R. Loube, *Competitive Issues in Special Access Markets*, NRRI Report 09-02.

¹³¹ *UNE Pricing NOPR*, π 83.

¹³² The FCC has not updated its own model. The FCC does require carriers frequently to update their switched line counts, but these line counts are not used to recalculate costs under the model, which the FCC has not run since 2004.

¹³³ A large portion of a broadband-capable network consists of facilities that are used in common with the voice network. Where a state uses a proxy model for cost, the state commission often decides explicitly whether the model should design a proxy network that is capable of supporting broadband services. Where a state bases support on embedded costs, unless the commission directs otherwise, carriers are likely to include broadband investment in their cost reports for cable and wire facilities and possibly for some central office equipment.

difficulty with this approach is that it can be very difficult to find a fair method to exclude broadband costs from a dual-purpose network that uses many common facilities.

At the other extreme, a state might increase the *Cost* term in any area where the supported carrier has deployed broadband-ready facilities. This policy would create a financial incentive for carriers to upgrade their networks enough to offer broadband.¹³⁴

2. Revenue

Revenue is the second term in the cost-based mechanism equation. It reflects revenue the carrier can reasonably expect in the same year of operations in which the costs are incurred.

Customer-paid revenue is the most obvious form of *Revenue*. The simplest approach is to use the carrier's actual projected revenue. Some states, including Maine and Nebraska, place a virtual "floor" under customer-paid revenues designed to prevent carriers from using high cost funding to maintain very low local rates.¹³⁵ These states set customer-paid revenue equal to the number of subscribers multiplied by a "benchmark" local rate that the state believes is affordable to customers. To the extent that the carrier charges rates lower than that floor or benchmark, high cost support does not subsidize that choice.

Revenue can also include other forms of subscriber-paid revenue such as state subscriber line charges.¹³⁶ A state can also add an amount representing the carrier's average revenue from vertical services.

Revenue can also include non-subscriber revenues such as net intercarrier revenue. If these non-subscriber revenues are not deducted from support, the carrier might recover some of its cost twice.

Revenue can also include federal universal service fund receipts. Determining whether all such support should be included requires some knowledge of separations as well as the history and purpose of these support programs. To be consistent, a state should either take an unseparated or "total company" approach to *Cost* and *Revenue*, or it should consider only intrastate *Cost* and intrastate *Revenue*. Three of the five major FCC high cost support programs

¹³⁴ The federal High-Cost Loop program for rural carriers has essentially done this by including all loop costs in the program, even when those loops are capable of providing high capacity services.

¹³⁵ Some states call this virtual rate floor a "benchmark local rate."

¹³⁶ Some states have established these fixed charges as a way of compensating ILECs for the use of loop facilities by interexchange carriers.

should be counted as *Revenue* in either case.¹³⁷ Table 5 explains the effects of those five major federal high cost programs on intrastate revenue requirements.

Table 5. Effect of Federal High Cost Programs on Intrastate Revenue Requirements

Program	Effect on Intrastate Revenue Requirement (IaRR)?
High Cost Loop	Yes. Federal support creates an “expense adjustment” that reduces IaRR and increases interstate revenue requirement. ¹³⁸
Local Switching Support	Yes. Support reduces IaRR by assigning more switching costs to interstate. ¹³⁹
High Cost Model Support	Yes. Support is aimed at enabling reasonable comparability of intrastate rates and therefore should be booked as intrastate revenue. ¹⁴⁰
Interstate Access Support	No. Support is interstate revenue.
Interstate Common Line Support	No. Support is interstate revenue.

3. Unregulated operations

Modern telecommunications networks provide multiple services, only some of which are regulated in the traditional sense. States should consider whether to include revenue from unregulated operations in the *Revenue* term of any cost-based support mechanism.

Digital Subscriber Line service (DSL) provides a prime example. In 1998 the FCC held that DSL service was an interstate telecommunications service.¹⁴¹ In 2007, the FCC went further and decided that DSL is an interstate “information service.”¹⁴² As a result of these decisions, an

¹³⁷ The IAS and ICLS programs produce only interstate *Revenue*. These programs were created incidental to FCC reductions to interstate access rates. Support from these two programs should be considered only if the state also uses unseparated *Cost* data.

¹³⁸ 47 C.F.R. § 36.631.

¹³⁹ 47 C.F.R. § 54.301.

¹⁴⁰ FCC, *Federal-State Joint Board on Universal Service*, CC Docket No. 96-45, Ninth Report and Order, 14 FCC Rcd. 20432 (1999) (subsequent history omitted), *π* 62.

¹⁴¹ FCC, *GTE Telephone Operating Cos. GTOC Tariff No. 1, GTOC Transmittal No. 1148*, 13 FCC Rcd. 22466, ¶ 1 (1998), *recon.*, 17 FCC Rcd. 27409 (1999).

¹⁴² FCC, *Appropriate Framework for Broadband Access to the Internet over Wireline Facilities*, CC Docket No. 02-33, Report and Order and Notice of Proposed Rulemaking, FCC

ILEC can invest in plant facilities, increasing its regulated plant account, can use that plant in common with unregulated DSL services, and can exclude much or all of the additional revenue from intrastate regulated accounts.

While state commissions cannot consider DSL revenues when they set the intrastate rates for telecommunications services, nothing in federal law prevents them from doing so when determining high cost support. Indeed, failing to account for such revenue could force the state's high cost fund to inadvertently support those DSL facilities,¹⁴³ a result that not all states would welcome. States can avoid that result by including DSL revenue in their support calculation, either on a wholesale basis¹⁴⁴ or a retail basis.¹⁴⁵

Similar concerns apply to revenue generated by video services provided over common facilities. As with DSL, federal preemption may make these revenues inadmissible in any state proceeding to set a carrier's rates, but calculating state high cost support is a different case. Where supported network facilities are used to provide unregulated services and the costs appear in the *Cost* term of the support calculation, a state may legitimately consider those activities in the *Revenue* term as well.

4. Examples of cost-based funds

Many states provide cost-based support. Some use different methods to estimate the costs of large companies (including RBOCs) and smaller companies. As is true for several hold-harmless mode states, states with cost-based funds often make adjustments for very low local rates.

- Arkansas organizes its carriers into four categories, roughly based on size. It uses two different cost-based methods for these categories:

05-150, 20 FCC Rcd. 14,853, ¶ 5 (2005). The FCC's order was upheld on appeal. *Time Warner Telecom, Inc. v. FCC*, 507 F.3d 205 (3rd Cir. Oct 16, 2007).

In prescribing the methods for categorizing DSL costs, the FCC allowed ILECs to sell DSL access to affiliates on a wholesale basis which it called "broadband Internet access transmission arrangements." For these "BIAT" services, ILECs may decide to offer the service "on a common carrier basis" or a "non-common carrier basis."

¹⁴³ This could occur for example, where: (1) the carrier has upgraded its loop facilities to support DSL; (2) the carrier offers BIAT service on a common carrier basis, including the DSL/BIAT investment in rate base; and (3) the state provides cost-based support to the carrier.

¹⁴⁴ Wholesale BIAT revenue would be equal to the revenue to the ILEC from DSL providers using its network, whether affiliated or not.

¹⁴⁵ Retail BIAT revenue would be equal to the retail revenue to the ILEC's DSL affiliate, adjusted, if necessary, for DSL services provided by unaffiliated companies.

- Arkansas uses a proxy model to estimate cost for its sole Category I carrier, AT&T. Estimated revenues are set equal to the FCC's published benchmark for its High Cost Model Support program.¹⁴⁶
- For its other three categories of carriers, Arkansas uses embedded cost methods, but it considers only loop costs.¹⁴⁷ Estimated revenues are set equal to the sum of its customer revenues plus any federal high cost support received. Customer revenues are deemed equal to \$28.70 per month (\$344.40 per year), which is roughly equal to the NECA-calculated national average cost per loop in 2005. The Arkansas fund pays support equal to all of the net revenue deficiency, within limits of the funding caps set for each category.
- California has two cost-based funds, one for large and one for small carriers.
 - California's "A Fund" supports rate-of-return carriers and provides support based on actual costs, as determined by a general rate case. The amount of the resulting subsidy is fixed for three years and is then stepped down over a six-year period. As discussed earlier, this "waterfall" provision gives the carrier an incentive to periodically undergo a rate case to re-establish the proper support level.
 - California's "B Fund" is also a cost based fund, applicable in this case to the four large ILECs in the state (AT&T, Verizon, Frontier, and SureWest). B-Fund costs are estimated using a cost proxy model run at the census block group level. Support from the fund is the difference between the results of the cost proxy model and a benchmark of \$36.00 per line per month.

¹⁴⁶ To set this benchmark the FCC prepares a list of statewide average cost of non-rural carriers, by state. The mean and standard deviation of this table of state data is calculated. The benchmark is set at the point two standard deviations above the mean. In 2009, the mean cost was \$21.43; the standard deviation was \$3.35. The benchmark was \$28.13. See <http://www.universalservice.org/about/governance/fcc-filings/2009/quarter-4.aspx> (report HC16 - High Cost Model Support Projected by State).

¹⁴⁷ Arkansas obtains each carrier's unseparated loop cost data from the carrier's filings with the National Exchange Carriers Association. Each carrier's revenues are set equal to the sum of its customer revenues plus any federal high cost support received. Customer revenues are deemed equal to \$28.70 per month (\$344.40 per year), which is roughly equal to the NECA-calculated national average cost per loop in 2005. The Arkansas fund pays support equal to all of the net revenue deficiency, within limits of the applicable category caps. Because categories 2 through 4 can have multiple carriers, Arkansas pro-rates support within categories if necessary to comply with the category caps.

- Colorado determines support for non-rural carriers using a cost proxy model. The carrier's modeled cost is then compared to the carrier's intrastate revenues. If modeled cost exceeds revenues, the carrier receives support from the state high cost fund. For rural carriers, Colorado uses the carrier's actual cost to determine the support level, although it has adopted a simplified method of estimating those costs. The Colorado commission reviews a one-page summary of each carrier's revenue requirement, as well as a summary of its intrastate revenues.
- After an initial three-year transition period, Kansas adopted a cost-based methodology. Support for rural carriers is based on embedded cost. For non-rural carriers, Kansas uses a cost proxy model that produces cost estimates at the wire center level and then disaggregates cost further between base rate areas within city limits and outlying areas. Non-rural carriers receive per-line support for wire center areas where modeled costs are above 135% of the state average.
- Maine's fund operates using embedded cost and rate-of-return principles. A Maine carrier's support is equal to the difference between its intrastate revenue requirement and its intrastate revenues. The revenue requirement is calculated through a simplified rate case. Revenues are estimated by multiplying the carrier's billing units for intrastate services (residential line, access charge minutes of use, etc.) by the carrier's rates. Maine adjusts support for low local rates by using a fixed benchmark rate for local service.
- Since 2005, Nebraska has operated a cost-based fund that uses a single-cost proxy model to estimate the costs of all its ILECs, both rural and non-rural. Nebraska establishes revenue per line as equal to the sum of the carrier's customer revenues (including SLC revenues), its average intrastate access charge revenues, and its federal USF support. Nebraska imputes local exchange customer revenues based on announced benchmark rates (\$17.95 for urban and \$19.95 for rural areas). Any carrier that has actual rates below this benchmark may increase its local rates to the benchmark but is not required to do so.

C. Bill credit mode

The third distribution mode for high-cost support is to mandate that telecommunications carriers provide explicit customer bill credits for customers who otherwise would pay high retail rates. The carrier is then reimbursed from the fund for credits actually granted.

Bill credit mode support is calculated using the following basic equation:

$\text{Support per Line} = \text{Local Service Rate} - \text{Benchmark Rate}$

The first term, *Local Service Rate*, is the rate for a basic package of voice services. It can include all fixed charges, including any state subscriber line charge. It can also include an

allowance for usage in local and extended local calling areas and even a limited amount of toll usage.

The second term, *Benchmark Rate*, is set at a level at which the state deems service affordable by most customers. Commissions can consider the average income of the state or community and the average local exchange service rate throughout the state generally.

The state's chief tasks in using the bill credit method are to define what parts of a customer's bill should be included in the *Local Service Rate* calculation and to set a standard for the *Benchmark Rate*. While these are not simple tasks, they allow the commission to avoid issues that bedevil the cost-based mode, such as how to measure the carrier's *Cost*, whether to use proxy models and how to estimate the carrier's *Revenue*. In essence, the bill credit mode decouples the process of ratemaking from the process of calculating support. Whether rates are regulated or unregulated, the support system responds to the consumer's actual cost.

Similarly, the bill credit mode avoids issues that arise in hold-harmless mode, such as whether a carrier's current revenues should be adjusted before using them as a base for future support and whether very low local rates should cause a downward adjustment to support. Very low local rates in the bill credit mode automatically generate no support.

The disadvantage of bill credit mode is that by reducing the customer's net cost, it could encourage rate increases. For such a support plan to work properly there must be some external constraint on the size of monthly bills. Without that constraint, carriers would have perverse incentives to raise rates so that credits and support would increase.

That constraint could come from regulation or from market forces. A third option is to support only a portion of the difference between the *Local Service Rate* and the *Benchmark Rate*. Supporting only a portion of that difference in support requires the remainder to be recovered from customers, a feature that could detract from universal service objectives but that creates a constraint on customer bills.

1. Examples of bill credit funds

Two state funds currently use the bill credit mechanism.

- Wyoming calculates a separate *Benchmark Rate* for residential service and for business service. Each *Benchmark Rate* is equal to the average state rate for that service, multiplied by 130%. Subscribers whose rates are above the Benchmark receive a credit on their bill; the carrier is reimbursed for the credit from the high cost fund.
- Wisconsin sets the *Benchmark Rate* at a level sufficient to purchase a standard service package of essential services. The package includes local service, the federal Subscriber Line Charge, access to 911, an allowance for long-distance

usage, and an allowance for calls within the local calling area.¹⁴⁸ The Wisconsin *Benchmark Rate* also varies by county, based on median income. If a customer's rate for the package of essential services does not exceed 1.5% of the county median household income, the customer will not receive any High Rate Assistance Credit. For example, if a county has a median household income of \$30,000, the benchmark rate would be \$37.50 ($= [\$30,000 / 12 \text{ months}] \times 1.5\%$). If the package of essential services is priced at \$37.50 or less, the customer would receive no credit. If the package is priced above the benchmark, in this case \$37.50, the customer receives a credit for a portion of the difference. The greater the difference from the benchmark, the greater the support percentage.¹⁴⁹

D. Auctions

Many economists advocate the use of "competitive bidding" or "reverse auctions" as a mechanism to allocate universal service funding. In such an auction the winner would be the bidder that is willing to provide Carrier of Last Resort (COLR) service while demanding the smallest public subsidy. Proponents maintain that this market-like mechanism could reduce the amount of existing subsidies to ILECs, while still maintaining universal service. Proponents also argue that auctions can identify the most efficient technology to serve an area¹⁵⁰ and can accurately identify the total stream of non-subsidy revenues that is available to each bidder.¹⁵¹

Both federal and state regulators have expressed interest in using auctions as a way of distributing universal service funding. The FCC said in 1997 that competitive bidding and auctions have many potential advantages and that it would "continue to review" competitive

¹⁴⁸ The local calling allowance in each area is related to the size of the local calling area.

¹⁴⁹ The actual calculation of credits is as follows:

Portion of Rate $\geq 1.5\%$ but $< 2\%$ of county median household income	50% credit
Portion of Rate $\geq 2\%$ but $< 2.5\%$ of county median household income	75% credit
Portion of Rate $\geq 2.5\%$ but $< 3\%$ of county median household income	85% credit
Portion of Rate $\geq 3\%$ of county median household income	95% credit

¹⁵⁰ For example, if wireless technology can meet the minimal service requirements set forth in the request for bids, a wireless bidder might be able to submit a lower bid than any wireline bidder.

¹⁵¹ In cost-based support, regulators must estimate carrier revenues in order to calculate support. This process can be controversial, since carriers have an incentive to try to exclude categories of revenue based on regulatory classifications and to make low estimates of future revenue. Auction advocates maintain that competitive bidding shifts changes these incentives. Since each bidder is likely to assume that other bidders are efficient, each bidder is likely to make realistic estimates of all future revenues, regardless of regulatory category.

bidding systems.¹⁵² The California Commission also has a longstanding interest in competitive bidding and auctions. In 1996 the commission indicated its interest in competitive bidding.¹⁵³ In 2007, the California commission stated that it did not regard the distribution method for its "B Fund" to be competitively neutral. It announced plans to replace the current method with a reverse auction mechanism.¹⁵⁴ The Wisconsin commission has said that if a local exchange carrier should seek to relinquish its status as an ETC, and if no other carrier is interested, the commission might conduct an auction.¹⁵⁵

Universal service auctions have drawn interest for decades. It does not appear, however, that there has been a single case, in the United States or elsewhere, of a successful reverse auction that allocated universal service subsidies in an area with an established wireline telecommunication network.

One problem is the added complexity of holding an auction for an area already served by an ILEC.¹⁵⁶ A theoretical benefit of auctions is that they reduce the amount of support needed to maintain universal service. In practice, however, auctions create risk for bidders that can actually increase the required subsidy unless the state forecloses that possibility in advance.

¹⁵² *USF First Report and Order*, ¶ 207 ("[T]here are many potential advantages to defining universal service support levels for rural, insular, and high cost areas through the use of a competitive bidding mechanism. We recognize, as did the Joint Board, that competitive bidding could supplement another forward-looking economic cost methodology in determining the universal service support levels because a properly structured bidding system requires competitors to reveal expected revenue opportunities. Accordingly, we will continue to review competitive bidding systems to determine whether competitive bidding could be used to determine universal service support through market-based mechanisms.")

¹⁵³ See California Public Utilities Commission, *Rulemaking on the Commission's Own Motion into Universal Service and to Comply with the Mandates of Assembly Bill 3643*, Order 96-10-066 (Cal. PUC Oct. 25, 1996) at 215-16, 260.

¹⁵⁴ See California Public Utilities Commission, Rulemaking 06-06-028, Decision 07-09-202, issued in Sept. 13, 2007, at 116. According to the response to a NARUC 2007 survey, California allows any COLR in a multi-COLR area to file a letter opting out of its COLR obligations within a geographic study area. However, the last COLR remaining may withdraw only upon approval of an application by the commission or a new COLR has been designated as a result of an auction.

¹⁵⁵ Wis. Admin. Code PSC 160.13(5)(c).

¹⁵⁶ Federal law may impose additional legal barriers to reverse auctions in the United States. If an ILEC loses an auction, a state commission may not be able to relieve the ILEC of obligations imposed by federal law. See 47 U.S.C. § 251(c) (additional obligations of incumbent local exchange carriers).

One way to limit fund expansion is to set a "reserve price" equal to the current high cost subsidy. Such an auction, however, could produce only one bidder, the ILEC. When Australia conducted a reverse auction, its only bidder was Telstra, the incumbent provider.

It is useful to assess the risks facing a potential bidder in any auction. Bidder A may intend to build its own facilities. For several reasons, the costs of those new facilities can be higher than the ILEC's current net plant account, possibly even higher than the ILEC's original cost. Labor costs have risen over the years. Some materials prices have also increased. Copper wire and poles, for example, are more costly than they were in the 1990s. In addition, any new facilities would also be likely to create a higher depreciation expense than that of most incumbents' existing networks. Therefore, Bidder A planning to construct its own facilities might well submit a bid higher than the ILEC.

Bidder B may intend to acquire existing facilities from others (including the ILEC), such as poles and wires. This introduces a different set of risks. A state commission that sponsors an auction might even provide a procedure to transfer those assets after the auction, or it might leave the bidder to its own devices. In either case, the bidder is unlikely to know in advance the final acquisition cost. Facing that uncertainty, Bidder B would increase its bid price.

Bidder C may plan to rely on purchased services. ILECs are required to provide carrier-to-carrier services, including UNEs, resale and collocation,¹⁵⁷ and ILEC services are often less costly than new construction. Yet the auction itself creates risk for Bidder C. If C submits the low bid and wins the auction, the ILEC would lose its existing universal service support. That could drive the ILEC into a business failure, depriving Bidder C of the services it needs to perform its contract.¹⁵⁸ Facing that risk, Bidder C would increase its bid price.

Auctions have been successful in developing nations such as India, Nepal and some South American countries. India also used reverse auctions to assign the right to build new mobile networks. Yet all these successful overseas auctions had an important difference: all anticipated the "greenfield" construction of new networks or facilities in currently unserved areas.

¹⁵⁷ In the U.S., the availability of UNEs has been cited as a complicating factor for reverse auctions. See V. Sorana, "Auctions for Universal Service Subsidies," *Journal of Regulatory Economics*, 18(1) (2000) at 57; Dennis Weller, "Auctions for Universal Service Obligations," *Telecommunications Policy*, 23 (1999), 645-674. A CLEC bidder might rely on resale or UNE loops for some or all areas. A cable company bidder would typically have facilities in some but not all areas and might also plan to rely on UNE loops or resale. A wireless carrier might rely on cell towers for the last mile, but would typically rely on special access circuits for backhaul.

¹⁵⁸ Valter Sorana notes that proponents of auctions "should consider implicitly the effects of incumbency." See V. Sorana, "Auctions for Universal Service Subsidies," *Journal of Regulatory Economics*, 18(1) (2000) p. 57.

Two members of Congress have proposed that auctions be used to reduce federal high cost support payments to wireless carriers.¹⁵⁹ Their draft bill would require the FCC to select up to two winning bidders in any area with at least three wireless providers that can participate in competitive bidding. In areas served by fewer carriers, the draft bill would require the FCC to continue providing high cost support at current levels. The legislation has not advanced at this writing.

International experiences suggest that auctions might have a role in promoting the deployment of broadband in the United States, because many areas are currently unserved by terrestrial facilities. Similarly, auctions might be useful to slightly reduce federal support to wireless carriers. The fundamental claim for auctions, however, is that they can allocate support for wireline voice services in the United States. Auctions appear far less promising in that context. It is perhaps no accident that no other country has turned to reverse auctions for universal service in developed areas.¹⁶⁰

E. Amount of support to competitive carriers

As noted in part IV, several states provide high cost support to competitive carriers. An essential step in providing support to such competitive carriers is to determine how the amount of that support should be calculated.

One option is to require the competitive carrier to demonstrate its own cost. No state commission has awarded support to a competitive carrier based on its own costs. Maine has said that it would do so if asked, but no competitive carrier in Maine has sought that support.

The second option is the Identical Support Rule. Under this rule, a competitive carrier receives per-line support equal to that provided to the ILEC serving a customer in the same location. For example, Kansas provides support to competitive ETCs based on the per-line support amount of the rural ILEC serving the same area.

Since 1999, the FCC has also used the Identical Support Rule to distribute federal support to competitive carriers.¹⁶¹ The federal rule has been controversial, and in 2007 the Federal-State Joint Board on Universal Service recommended that it be repealed.¹⁶²

¹⁵⁹ See, e.g., "Discussion Draft" legislation released by Congressman Boucher and Congressman Terry on November 6, 2009.

¹⁶⁰ S. Wallsten, *Reverse Auctions and Universal Telecommunications Service: Lessons from Global Experience*. Washington, D.C., Technology Policy Institute (April 2008).

¹⁶¹ 47 C.F.R. § 54.307(a).

Proponents of the Identical Support Rule consider it to be competitively neutral. For example, when the FCC adopted the Identical Support Rule for federal support, it said that “[u]nequal federal funding could discourage competitive entry in high-cost areas and stifle a competitor's ability to provide service at rates competitive to those of the incumbent.”¹⁶³

The Identical Support Rule has several disadvantages. First, it breaks the connection between cost and the subsidy, allowing some carriers to receive support well in excess of their actual costs. A competitive ETC (including wireless carriers) receives support based on the costs incurred by the ILEC, which quite likely has a different cost structure. That ILEC is by definition a high-cost carrier or it would not be receiving support. This result can be inappropriate if the competitive carrier has not been required to build facilities or if, using a different technology, the competitive carrier has lower costs than the incumbent.

Second, the Identical Support Rule assumes that service is provided at the customer's billing address. Yet mobile services are, by definition, accessible throughout the network, not merely at the subscriber's billing address. The customer location problem is particularly awkward when the wireless customer cannot get service at his or her billing address but nevertheless subscribes to the mobile service for travel.

Third, the Identical Support Rule subsidizes multiple networks and therefore can induce uneconomic entry. At the federal level, the Identical Support Rule has created an incentive for wireless carriers to become designated ETCs in states with high ILEC per-line support amounts. Several state commissions in such states have been faced with many ETC petitions, particularly from mobile carriers. This feature can also greatly increase the fund size.

Fourth, the Identical Support Rule inaccurately assumes that one access line won by a competitor means one line lost by an ILEC. The FCC's original premise for the federal rule was that a competitor “captures” a line from the ILEC. In reality, the overall number of lines increased as many customers added wireless phones. This feature can also cause unforeseen increases in fund size.

The FCC, in response to the rapid growth in the federal high cost fund caused by the rapid proliferation of competitive ETCs (most of them wireless providers), implemented a cap on the total annual amount of high cost support expended for competitive ETCs. The cap, an interim step until the FCC undertakes federal USF reform, freezes support for competitive ETCs at March 2008 levels. (FCC 08-122). Finally, the Identical Support Rule behaves in surprising ways as competitive carriers' market shares changes. In Appendix C we explain a plausible but

¹⁶² Federal-State Joint Board on Universal Service, *Matter of High-Cost Universal Service Support*, WC Docket No. 05-337, Recommended Decision, FCC 07J-4, 22 FCC Rcd. 20477 (*Three Funds RD*) π 35.

¹⁶³ FCC, *Federal-State Joint Board on Universal Service*, CC Docket No. 96-45, Ninth Report and Order, 14 FCC Rcd. 20432, π 90 (1999) (subsequent history omitted).

simplified scenario with a facilities-based competitor, a cost-based ILEC support mechanism and the competitor's support calculated under the Identical Support Rule. The simulation results are tabulated in Appendix C and summarized in Chart 3 below.

Chart 3. Support and Costs for ILECs and Competitors with Identical Support Rule

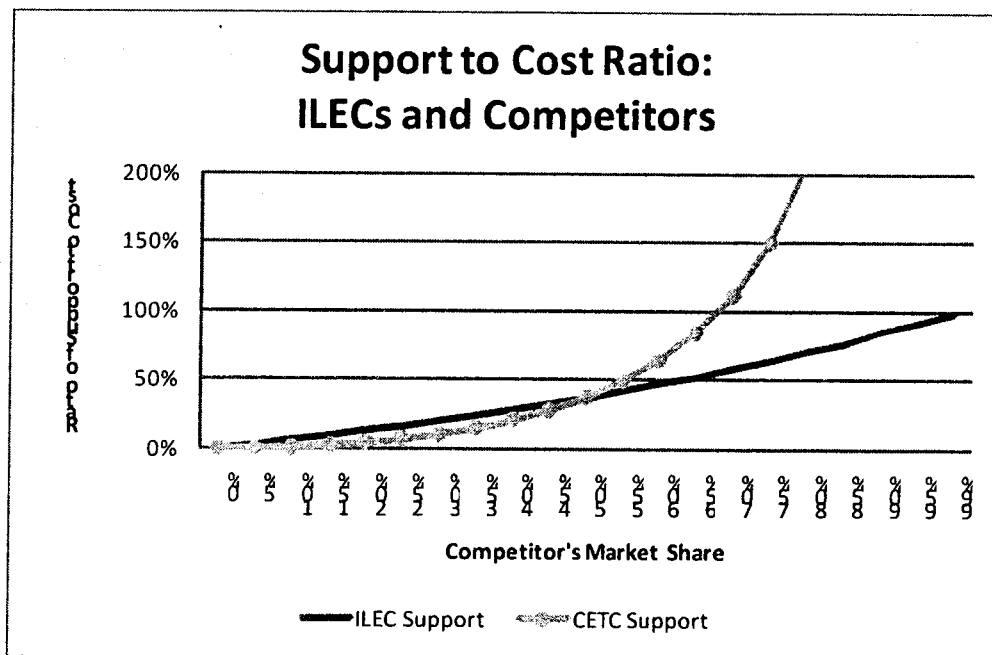


Chart 3 shows that the Identical Support Rule is disappointing in two ways:

1. When the competitor's market share is small, support is only a small share of its fixed costs. Therefore, when a competitor contemplating entry into a local exchange market anticipates a small market share, support is unlikely to affect that entry decision.¹⁶⁴

2. As the competitor's market share increases, CETC support increases exponentially and can far exceed total cost. This occurs because, as the CETC's market share increases, the ILEC's cost per line increases, as does its support. At the same time, the CETC's per-line support amount increases as its per-line cost decreases. In this illustration, when the CETC market share reaches 90%, its support exceeds 500% of its cost.¹⁶⁵

¹⁶⁴ The exception is where the competitor has little or no fixed cost. In that case, the Identical Support Rule can provide support greater than cost even at a small market share.

¹⁶⁵ We recognize that this extreme hypothetical result would be unlikely to occur in practice. Long before a CETC received that support equal to 500% of cost, the state commission would be likely to intervene.

This behavior seems counter-intuitive to many policy makers. One would hope that a support system that incorporates the Identical Support Rule would treat ILECs and competitors the same. Yet the reality is that the Identical Support Rule treats ILECs and competitors quite differently and can produce unforeseen interactions with other support rules. A state that offers support to competitive carriers should carefully analyze the interactions among all its support rules. The analysis should consider a range of conditions, including circumstances where the ILEC is no longer dominant. The analysis should evaluate the incentives created by state support, and how those incentives are likely to affect overall fund size.

On the other hand, the results would be even more extreme if less conservative assumptions are used. Those would be that more than 60% of costs are fixed, that competitors often gain lines more rapidly than ILECs lose lines, and that a competitor's costs are often lower than the ILEC's costs.

VI. Collecting State High Cost Funds

A. State practices

States are collecting significant sums of money for their universal service activities. Table 6 summarizes the overall fund revenues of states that have high cost funds. As Table 6 shows, the state fund ranges from a high of \$665 million in California to a low of \$3.26 million in Wyoming. These amounts include all universal service revenues, not merely those expended as high cost support.

*Table 6. Overall Fund Revenues for States Providing High Cost Support*¹⁶⁶

State	Revenue (\$MM)	Fiscal Year (2007-08 unless indicated otherwise)
Alaska	4.2	2008
Arizona	0.8	
Arkansas	13.2	2007
California	665.	
Colorado	64.2	
Idaho	2.0	
Illinois	9.9	
Indiana	15.8	
Maine	8.0	
Nebraska	51.	
Nevada	0.0	
New Mexico	23.	
Oklahoma OUSF	5.3	
Oklahoma HCF	37.	
Oregon	49.	
Pennsylvania	33.8	
South Carolina	54.6	2007
Texas	649.	FY 2006
Utah	6.6	
Wisconsin	6.0	
Wyoming	3.3	

¹⁶⁶ Information for Texas was provided through interview rather than through our survey.

B. The revenue base

Nearly all states raise these funds through *ad valorem* surcharges on telecommunications services. Idaho and Arizona are the exceptions, with each state imposing both a monthly surcharge on lines and a second surcharge on toll usage.¹⁶⁷ Although states have shown interest in FCC proposals to impose a surcharge on telephone numbers or connections, no state has adopted such a plan.¹⁶⁸

All states with *ad valorem* surcharges exempt wholesale charges between carriers. Because of this exemption, a niche competitor (like a reseller) that provides only a retail service can compete with a vertically integrated provider that also provides its own facilities. Therefore, this exemption maintains competitive neutrality as between vertically integrated providers and providers who purchase upstream component services.

Among states that levy *ad valorem* surcharges, nearly all impose their surcharges only on intrastate services. South Carolina was the only state with a high cost fund that assesses both intrastate and interstate revenues.¹⁶⁹ Vermont imposes a surcharge on both intrastate and interstate revenues for other universal service purposes.¹⁷⁰

Several states expressed concern in our survey about the declining base of intrastate revenue. Some states suggested that wireless and VoIP providers should be required to contribute to state universal service programs. Oregon noted the difficulty in keeping its surcharge rate at a reasonable level while the revenue base declines.

¹⁶⁷ In Idaho, the line charge is \$0.10 per residential line and \$0.17 per business line and the toll surcharge is \$0.003 per minute. Arizona has a two-category system. Category One imposes a line charge on providers of basic local exchange service, wireless service, paging service and other Commercial Mobile Radio Service providers that interconnect with the public switched network. In 2009 these providers pay a monthly rate of \$0.006471 per access line and \$0.064714 per interconnecting trunk line. Category Two providers are intrastate toll service providers, who pay a monthly surcharge of 0.2485% of intrastate toll revenues.

¹⁶⁸ Colorado, New Mexico, and Pennsylvania reported that they have evaluated the possible impact of the FCC plan. All three expressed concerns, citing a shift in costs to the residential ratepayer.

¹⁶⁹ Vermont operates a universal service fund based on a surcharge on intrastate and interstate bills, but it does not use the proceeds for high-cost support.

¹⁷⁰ Vermont's universal service program supports the state's enhanced 911 program, Lifeline and benefits for the hearing impaired. 30 Vt. Stat. Ann. § 7511.

C. Contributing services, exemptions

All states require contributions from retail switched wireline carriers. Every responding state with an *ad valorem* surcharge for universal service told us they require contributions from ILECs, CLECs and IXC's, or from their customers.

States do not agree about requiring contributions from wireless carriers. A majority of states reported that they require wireless providers to contribute.¹⁷¹ South Carolina wireless providers only contribute if they have obtained federal ETC status in that state.

Contribution from VoIP providers is an evolving area of law. The Eighth Circuit Court of Appeals decided in 2009 that Nebraska could not impose a universal service surcharge on the revenues of a nomadic VoIP provider.¹⁷² Later in 2009, the Nebraska and Kansas commissions asked the FCC to explicitly permit such surcharges, but the FCC had not acted on the petition at this writing.¹⁷³

Fixed VoIP providers present different issues than nomadic VoIP providers. In many states, fixed VoIP providers have obtained state certificates to operate as telecommunications carriers.¹⁷⁴ In addition, fixed VoIP has more capabilities to identify the location of the end points of switched calls. The impossibility of identifying these locations was a key factual finding that supported the special treatment afforded to nomadic VoIP.

¹⁷¹ Based on survey responses, wireless carriers contribute in Alaska, Arizona, Arkansas, California, Colorado, Indiana, Kansas, Maine, New Mexico, Oklahoma, and Utah. They do not contribute to state funds in Idaho, Illinois, Nebraska, Nevada, Oregon, Pennsylvania, Wisconsin, or Wyoming.

¹⁷² *Vonage Holdings Corp v. Nebraska Public Service Comm'n.*, Case No. 08-1764, 564 F.3d 900 (8th Cir. 2009). "Nomadic" means that the service can be used at any Internet port with sufficient bandwidth, regardless of location. Fixed VoIP services are provided over fixed facilities, such as cable TV distribution lines.

¹⁷³ See, FCC, *Petition for Declaratory Ruling of the Nebraska Public Service Commission and the Kansas Corporation Commission for Declaratory Ruling or, in the Alternative, Adoption of Rule Declaring that State Universal Service Funds May Assess Nomadic VoIP Intrastate Revenue*, FCC WC Docket No. 06-122, petition filed July 16, 2009.

¹⁷⁴ In many cases large fixed carriers see other benefits from their status as certificated carriers, including interconnection benefits, arbitration of agreements, and availability of telephone numbers.

Several states reported that they require some VoIP providers to contribute to state high cost funds.¹⁷⁵ Other states reported receiving contributions only from fixed VoIP services or only from carriers with certificates to operate as intrastate telecommunications carriers.¹⁷⁶ Several states reported that the status of VoIP contributions is unsettled. These states are proceeding cautiously in light of the difficulties that Nebraska experienced.¹⁷⁷

Modern telecommunications include new kinds of services other than the traditional telephone subscriptions with monthly bills. These newer products include prepaid cards and prepaid wireless phones. The retail outlets that sell these cards and phones have no traditional relationship to the state utility commission or its third party collection agent. It would be inefficient to collect surcharges from all these retail locations, which can number in the thousands. Where a state imposes a universal service surcharge on such sales, the underlying carrier typically reports the revenue, either upon consignment of the merchandise to the retail outlet or upon receiving a report that the merchandise has been sold.¹⁷⁸ The carrier often applies a "safe harbor" percentage to exclude interstate services from its reported revenues or sales.

A few states have adopted *de minimis* exemptions to contribution requirements.

- One approach is to exempt carriers with little revenue. Maine exempts carriers with less than \$12,500 intrastate revenue per quarter. Wisconsin exempts carriers with less than \$200,000 of intrastate revenues.
- Another approach is to exempt carriers that owe small payments. This approach is used in Alaska (\$100 per year), Colorado (\$10,000 per year), Illinois (\$2,400 per year), and Pennsylvania (\$120 per year).

Administration of contributions has become more difficult due to regulatory changes, particularly regarding wireless and VoIP providers. At one time, there existed a one-to-one

¹⁷⁵ Kansas, Maine, Nevada, New Mexico, Oklahoma, and Wyoming reported, without further elaboration, that VoIP providers are contributing to their funds.

¹⁷⁶ Illinois and Nebraska reported that fixed VoIP providers but not nomadic VoIP providers are required to contribute. Indiana, Pennsylvania, and South Carolina reported that only certificated VoIP providers are required to contribute. Oregon reported that VoIP providers are not required to contribute, but the largest VoIP provider in Oregon elected to be certificated and does pay into the state fund.

¹⁷⁷ For example, New Mexico recently dismissed a pending case against VoIP providers in its state. Some nomadic VoIP providers in Kansas are refusing to contribute to the Kansas fund.

¹⁷⁸ See FCC, *Regulation of Prepaid Calling Card Services*, WC Docket No. 05-68, Declaratory Ruling and Report and Order, FCC 06-79 (rel. June 30, 2006) (requiring prepaid calling cards to contribute to federal universal service funds based on interstate revenues).

mapping: all certificated carriers made contributions, and all contributions came from certificated providers. Today, this relationship is no longer valid, but most states still use certification as a source of information to track service providers and assess contributions. Some states require VoIP providers to be certificated,¹⁷⁹ while others do not.¹⁸⁰

Some states obtain information from other sources to track contributors. These include annual reports, specialized databases and registries, FCC databases, and the USAC website. Nebraska reports that it expends substantial resources on tracking carriers. The Nebraska staff has created a contact database (which all carriers are expected to update on an annual basis) as well as a communication provider registry. In addition, the Nebraska staff obtains information from the Secretary of State's website, newspapers advertisements and the yellow pages. Some states rely on their third-party fund administrator to track contributors.

D. Carrier and customer surcharges

Where a state imposes a surcharge on telecommunications services, it must decide whether to impose the surcharge on carriers (seller's retail revenues) or on customers (buyer's retail charges). The differences can affect what customers must pay, how the charge is explained to customers, and whether high cost funds collected by carriers are protected from that carrier's creditors.

Table 7 lists the surcharges reported by the survey respondents that operate high cost funds and that impose percentage surcharges. The surcharges range from fractions of a percent to 7.12% in Oregon. About half of the states levy the surcharge on the customer's retail bill and the other half impose the surcharge on the carrier's retail revenues.

Table 7. State Surcharge Rates

State	Surcharge rate	Base
Alaska	1.05%	Seller's retail revenues
Arkansas	1.49%	Buyer's retail cost
California A fund	0.13%	Buyer's retail cost
California B fund	0.25%	Buyer's retail cost
Colorado	2.20%	Seller's retail revenues
Illinois	0.36%	Seller's retail revenues
Indiana	5.38%	Buyer's retail cost
Maine	1.21%	Buyer's retail cost
Nebraska	6.95%	Buyer's retail cost

¹⁷⁹ Indiana, Nevada, South Carolina, and Wisconsin reported that VoIP providers are required to be certificated.

¹⁸⁰ Maine, Nebraska, New Mexico, Pennsylvania, and Utah reported that VoIP providers are not required to be certificated.

State	Surcharge rate	Base
Nevada	0.00% ¹⁸¹	Seller's retail revenues
New Mexico	2.15%	Seller's retail revenues
Oklahoma	0.60%	Seller's retail revenues
Oregon	7.12%	Buyer's retail cost
Pennsylvania	1.11%	Seller's retail revenues
South Carolina	3.57%	Seller's retail revenues
Texas	3.4%	Seller's retail revenues
Utah	0.25% ¹⁸²	Buyer's retail cost
Wyoming	1.00%	Seller's retail revenues

Some states reset their surcharge rates frequently. Kansas sets a new rate annually.¹⁸³

1. Buyer surcharges

Approximately half the states with surcharges impose those surcharges on buyers. These surcharges can operate in the same manner as a state sales tax. The tax or surcharge falls on the customer who normally must pay it at the time of sale. Since the surcharge falls on the customer, the customer must be able to prove that the charge was paid. Accordingly, all such charges require that the charge be shown on the customer's monthly bill or invoice of sale.¹⁸⁴ The surcharge is described by the following formula:

$$USF \text{ Charge on Customer} = \text{Rate} \times \text{Retail Bill}$$

With this kind of surcharge, as with sales taxes, the seller acts as the collection agent of the state for the USF surcharge. The proceeds are held in trust for the state fund. This method can help insulate surcharge funds from the carrier's creditors if a carrier or service provider cannot meet its debts.

The buyer surcharge method also avoids any controversy about the proper rate to show on the customer's bill. As seen below, this is sometimes an issue with gross revenue surcharges.

¹⁸¹ Nevada had no high cost distributions in 2008 and 2009 and covered administrative costs with an accrued fund balance.

¹⁸² Utah recently reduced its rate from 0.45% to 0.25%.

¹⁸³ Vermont, which does not have a high cost fund, sets a universal service rate annually for other public benefit programs.

¹⁸⁴ Similarly, state sales tax laws usually obligate sellers to list the tax amount on any receipt produced for the sales transaction. If a buyer is audited and cannot produce a sales tax receipt showing that he or she has paid the sales tax due on a purchase, the buyer may have to pay the tax again to the state tax department.

2. Gross revenue surcharges

Approximately half the states with surcharges impose those surcharges on sellers. These surcharges can operate in the same manner as a state or local gross revenue tax, such as those commonly imposed to support utility commissions. Some state statutes may limit universal service surcharges solely to surcharges on carriers.¹⁸⁵ The surcharge is described by the following formula:

$$USF \text{ Charge on Carrier} = Rate \times Gross \text{ Revenue}$$

States differ in whether they allow the cost of gross revenue surcharges to be passed through to consumers as explicit line items. Pennsylvania statute prohibits separate line items for recovery of state universal service surcharges.¹⁸⁶ Most states permit or require these line items.

When a gross revenue surcharge is passed through as a separate line item on a retail bill, the rate can properly be slightly higher than the rate that the carrier itself pays. For example, Oregon imposes a gross revenue surcharge of 6.65% on carriers and allows carriers to add retail line items on customers' bills at 7.12%. The dollar amount of surcharge is the same in both cases. In states with smaller surcharge rates, this difference can be small enough to be ignored.

Kansas allows some carriers to place a fixed monthly charge on customer bills, while it allows other carriers to impose a percentage surcharge. The Kansas commission approves three separate fixed surcharges for AT&T, Embarq, and all rural ILECs. Other carriers, such as IXC's and CLECs, may impose a percentage surcharge.

3. Net revenue surcharges

Gross revenue surcharge systems are sometimes criticized on the grounds that the surcharge rate shown on the customer's bill exceeds the surcharge rate on the carrier's revenues. While this rate difference is mathematically proper,¹⁸⁷ it still frequently generates an adverse reaction. Some people see gross revenue surcharges that are passed through to consumers at a higher rate as a "tax on a tax."

A third option exists that neither imposes a surcharge directly on the customer nor allows the customer's line item rate to exceed the carrier's surcharge. This third option is a "net revenue surcharge." The FCC uses this method for its own universal service surcharge. It is described by the following formula:

¹⁸⁵ For example, 47 U.S.C. § 254(d) requires that the FCC's programs be funded by a surcharge on carriers.

¹⁸⁶ 52 Pa. Code § 63.170.

¹⁸⁷ See section VI.D.2.

$$\text{USF Charge on Carrier} = \text{Rate} \times (\text{Gross Revenue} - \text{Prior Period Payment})$$

Like a collect-and-remit sales tax, the rate stated on the customer's retail bill can properly be equal to the rate imposed on the carrier.

VII. Administration and Evaluation

A. Administration

States use one of three methods to administer their universal service funds. The first method is for the state to administer the program itself, either through the regulatory commission or a combination of agencies. Nebraska and Wyoming use their commissions as both the fund administrator and fund custodian.

In several states the state commission manages the funds, but other agencies serve as fund custodians. California funds are held by the California State Controller. In South Carolina the state treasurer retains custody of the fund, but the commission administers it. In Utah, the Public Service Commission established the fund and sets policy for its operation. The Utah Division of Public Utilities (DPU) serves as the fund administrator and custodian. Wisconsin keeps funds custody in the hands of the State Treasurer, but it contracts accounting, billing, and reimbursement work to an accounting firm.

The second method is to assign administration to an ILEC or an industry coalition.

- Colorado uses an ILEC, Century Telephone Company, as the custodian of the state USF.
- The Illinois Commerce Commission appointed Illinois Small Exchange Carrier Association based on the organization's expertise dealing with small ILECs.

The third method is to select or create a third party administrator.

- Most states use one of several companies that specialize in such work, selecting the administrator through competitive bidding. These include Arkansas, Arizona, Indiana, Kansas, Maine, Nevada, New Mexico, Oklahoma, and Pennsylvania.
- Oregon keeps custody of its own funds, but it uses a third party administrator for accounting and delinquency work.
- Alaska and New York (which does not have a high cost fund) each have formed single purpose corporations to administer some universal service functions.¹⁸⁸

The cost of administration varies greatly depending on the complexity of the fund. States that contracted with a third party reported a wide range of costs, from a high of almost \$3 million for the administration of California's A and B Funds, to lows of \$25,500 and \$30,000 for the

¹⁸⁸ Alaska formed the Alaska Universal Service Administrative Company (AUSAC), the members of which include all companies that provide intrastate telecommunications services in Alaska.

Idaho and Maine funds. Among states using industry-based and third-party administrators, most reported costs in the \$100,000 to \$300,000 range. Nebraska self-administers and reported annual administrative costs of \$620,000, while Wyoming's fund, which is much simpler than Nebraska's, reported annual administrative costs of \$72,000.

B. Program accountability and evaluation

Our survey showed that state commissions have clear ideas about the purposes of their universal service programs. Most commissions cited broad objectives that often paralleled federal law.¹⁸⁹

- Colorado has established a goal of making basic service available and affordable for all its citizens.
- Idaho and New Mexico seek to maintain local rates at reasonable levels and toll rates at reasonably comparable prices to the rest of the United States.
- Kansas seeks to ensure that every citizen has access to a first-rate telecommunications infrastructure providing excellent services at affordable rates.
- Pennsylvania seeks to encourage "the accelerated deployment of a universally available state-of-the-art, interactive, public switched broadband telecommunications network in rural, suburban and urban areas."¹⁹⁰

A few states have established quantified goals.

- Nebraska set a 96% penetration rate as a goal of its universal service program.
- California reports having established the goal of 95% voice penetration.
- New Hampshire does not have a high cost fund, but its statutes require the state commission annually to assess the statewide penetration rate and ensure it does not fall below the national average.
- Wyoming has decided that no rates for basic service should be higher than 130% of the statewide average.

All the state commissions we interviewed well understand the general directions of their programs. Nevertheless, a state with quantified goals stands a better chance of conducting a meaningful evaluation of its program's success.

¹⁸⁹ See 47 U.S.C. § 254(b).

¹⁹⁰ 52 Pa. Consol. Stat. Ann. § 63.161(1).

VIII. Steps in Establishing a High Cost Fund

The preceding sections have been largely descriptive. This section offers a structured guide to decision-making. It aims to assist state commissions and state legislatures in deciding whether they need a state fund and, if so, how best to establish one. On many questions, the economic and political circumstances vary from state to state. We do not offer a single recommendation. Rather, we offer observations about advantages and disadvantages of particular choices.

A. Is a fund needed?

The most basic question facing a state commission or legislature is whether a high cost fund is needed. To answer this question, the state will first want to assess environmental factors in the state, notably the economics of the incumbent local exchange industry.¹⁹¹

1. Environmental factors

A state high cost fund is an intervention in the economic conditions of the state's telecommunications industry. Before establishing such a fund, therefore, a state commission should first understand market conditions. As discussed above,¹⁹² the commission should survey the extent of competition in the state and consider whether competition, in some or all parts of the state, has advanced so far that universal service goals can be met without governmental intervention.

A state commission should also examine the economics of the ILEC business in the state. We discussed above the main ILEC revenue streams and the factors affecting those revenues.¹⁹³ A state evaluating the need for a high cost fund should evaluate the foreseeable trends of those revenue streams. This survey should include the ILECs' line counts, subscriber revenues, access traffic, net intercarrier revenues, and average total revenue per unit (ARPU). The state commission might also want to estimate future trends for three to five years, taking account of any probable market-changing events, such as the introduction of cable voice service in ILEC service areas.

The revenue survey should include revenue from federal universal service support. Particularly for smaller "rural" carriers, federal support can provide a large share of an ILEC's total revenues. Even without regulatory changes, the amount of federal support shifts over time.

¹⁹¹ The considerations for this topic were covered in section III above.

¹⁹² See section III.A.

¹⁹³ See section III.B.

High Cost Loop support in particular can change dramatically over a period of years.¹⁹⁴ In some cases, recent or anticipated losses or gains in federal support could affect a state's decision about whether and where high cost funding might be needed.

Revenue can also be affected by any state plans to make substantial revisions to intrastate rates. Historically, mandated changes to retail rates and access charge rates have often been the proximate cause of new state high cost funds. Conversely, if a state has decided to establish a high cost fund, it should also consider whether rate reforms should be imposed simultaneously.

A state considering establishing a high cost fund should also evaluate the distribution of ILEC costs among study areas and wire centers. We explained above how costs vary among wire centers nationally.¹⁹⁵ But states are not all alike, and each state's need for a high cost fund will depend on its own cost distribution. State A may be a rural state with some mountainous areas. State A would find its own cost distribution skewed toward the high-cost end of the spectrum, with many wire center areas having monthly costs above \$50. State B may have a relatively homogeneous population density pattern and few areas of challenging terrain. State B's costs for nearly all exchanges may lie in the safe zone with costs below about \$30.00. State A would need a high cost program more than state B.

In evaluating cost, a state should consider whether differences within individual wire center areas matter economically. As explained above,¹⁹⁶ cost differences within wire centers are economically relevant when the local exchange market is competitive in some portions of existing wire centers. Success by a competitor who serves only the "hole" surrounding a wire center building can drive up the ILEC's average costs, erode traditional implicit support flows and increase the need for explicit support.

We discussed above the FCC's opinion in 1997 that the proper task for a state universal service fund is to make subsidies explicit.¹⁹⁷ Potentially the largest of the three implicit transfers is that between urban and rural areas. Before undertaking to make this transfer explicit, the state should assess the likely size of that transfer, an amount that is a function of both the state's cost structures and its rate designs. Some state commissions will find that making explicit all of the currently implicit urban-to-rural support flow requires a fund that is dauntingly large.

¹⁹⁴ The High Cost Loop program allocates a capped amount of support over the highest cost loops in the nation. A carrier that five years ago had costly loops may today have only moderately expensive loops, in part because its own investment has depreciated and in part because other carriers have installed even more costly networks.

¹⁹⁵ See section III.C.1. and Charts 1 and 2.

¹⁹⁶ See section III.C.2.

¹⁹⁷ See section III.D.

Table 7 summarizes environmental factors that may affect a state's need for a high cost fund.

Table 7. Factors Affecting the Need for High Cost Funds

Environmental factor	More need for a state fund	Less need for a state fund
Competition	Facilities-based competitors avoid higher cost areas.	Facilities-based competition is ubiquitous or widespread.
	Competitive networks depend on ILEC for linchpin services.	Competitive networks are independent.
Subscriber revenue	ILECs are losing low-cost or high-profit subscribers.	ILEC local rates are currently low or ILECs have other revenue sources.
	Commission mandates de-averaging of local rates.	De-averaged rates are affordable.
	ILEC revenues are limited to regulated services.	ILECs produce unregulated Internet or video revenue from using common network assets.
Intercarrier revenue	ILEC access revenue is eroding.	ILECs have low access rates or are not dependent on access revenues.
	Commission mandates access rate reductions.	Commission allows local rates to increase following access rate reductions.
	FCC mandates lower intrastate access rates.	FCC creates new federal mechanisms to compensate intrastate access rate reduction.
Federal universal service funds	Insufficient federal USF	Sufficient federal USF
	Rural areas are served by large "non-rural" ILECs.	Rural areas are served by "rural" ILECs.
	Federal support is decreasing.	Federal support is increasing.
Cost	State has heterogeneous costs, large areas with high per-customer cost and high average local exchange rates.	State has homogeneous costs, usually due to uniform population densities and uniform topography. State has low average local exchange rates.

2. Alternative mechanisms

A state high cost fund is not the only tool available to support universal service. States have used a variety of regulatory tools to maintain affordable local rates in high-cost areas. Whether these tools are still viable is an important question in considering whether a state needs a new high cost fund.

a. Traditional rate designs

Traditional rate designs can be a useful tool to defer or avoid creating an explicit high cost fund. As discussed above,¹⁹⁸ the FCC and others have criticized geographic rate averaging in the wireline business. The perceived harms include subsidizing ILEC inefficiencies and deterring entry by new wireline competitors in subsidized areas. Despite the criticisms, rate averaging has been a durable mechanism, at least for large carriers. If a state commission concludes that geographic rate averaging remains a viable universal service strategy, one effect of that decision is a reduced need for an explicit high cost fund.

On the other hand, implicit support mechanisms can actually increase the ultimate demand for high cost support. Sometimes those implicit mechanisms can make it harder for essential carriers to compete. The burden of these transfers typically falls most heavily on urban business customers of ILECs who are the prime targets of competitors. To the extent that competitors win these customers, the ILEC's implicit support flow declines and the ILEC becomes more likely to seek explicit support. Therefore, reducing or eliminating implicit support flows can be a sensible precaution against future demands.¹⁹⁹

Value-of-service rate structures are another customary mechanism for achieving universal service.²⁰⁰ In addition, many states historically set high rates for long distance calling and for advanced features, using the additional revenues to reduce local rates. These mechanisms have become increasingly precarious in recent years. Many states have abandoned value-of-service retail pricing. Toll rates have fallen to a fraction of the rates charged in the 1980s, and most states have reduced intrastate access rates. Today, local exchange competitors routinely offer advanced features as an integral part of their service bundle.

b. Revenue pools

Some states have maintained "toll or access charge pools." These financial arrangements typically offer small carriers the opportunity to share toll or access revenues and costs with other pool participants. Participating ILECs can receive pool revenues on the basis of their cost and their volume of traffic. These pools can increase ILEC revenue in rural areas and could reduce pressure to establish an explicit high cost fund. Toll or access pools do not function well in a competitive environment, however, because net contributors seek to leave the pool. These pools in many states have been eliminated. Some states replaced the pooling arrangement with an explicit state support mechanism.

¹⁹⁸ See section III.D.3.

¹⁹⁹ If eliminating implicit support leads to high rural rates, that could increase the need for a high cost fund rather than reduce it. For example, Wyoming introduced its high cost fund in response to retail rate de-averaging.

²⁰⁰ See section III.D.3.

Some states continue to rely on their Access Charge regimes as a way to avoid a high cost fund. Kentucky and Washington allow carriers to charge an additional intrastate access charge; revenues from these charges help to cover local carrier costs and so help avoid local rate increases. The uncertain future of access charges suggests that this approach will be short-lived. If the FCC does sharply reduce interstate and intrastate access charges, pressure will increase for states to establish or expand high cost funds.

c. Line extension policies

While states generally assign ILECs carrier of last resort duties, those duties are often limited by line extension policies. Many states allow ILECs to impose line extension charges for lines constructed to new locations. These construction charges can increase ILEC revenue in rural areas and can marginally reduce the pressure to establish an explicit high cost fund.

In sum, some of the traditional mechanisms supporting universal service have not proven durable in the age of competition. Mechanisms such as value-of-service pricing, toll pools, and additional access charges no longer function well in the competitive environment and have actually become targets for reform. On the other hand, some rate mechanisms such as local rate averaging and line extension charges could marginally reduce the need for a state high cost fund.

3. Risks of explicit funds

We discussed above some of the advantages and difficulties of converting implicit support flows (or "implicit subsidies" as the FCC called them) into explicit support payments.²⁰¹ Making a subsidy flow explicit creates some additional risks.

One new risk is that even where an explicit support program replaces a longstanding implicit flow, the public may object. Explicit support programs typically generate more opposition than implicit support mechanisms. For example, an urban customer may for years contentedly pay a local rate that supports rural customers, but then object to a new explicit universal service program that replaces the implicit mechanism.

Explicit programs also can generate increased opposition from particular regional or industry groups. With an explicit fund, it is usually a simple matter to develop a plausible list of "winners" and "losers," either by region or by industry sector. In universal service, groups that contribute more than they benefit often candidly state that their opposition arises chiefly from self-interest.

Explicit funds can blur the traditional boundary between public and private funds and make universal service monies subject to legislative appropriation. For most implicit support mechanisms (such as those between urban and rural customers), it is usually understood that all of the money involved is utility revenue. State legislatures may impose a tax on these funds, but the funds are considered private property and they are not subject to appropriation. A legislature

²⁰¹ See section III.D.

would not normally pass a law, for example, requiring a utility to pay for a public school or pave a public highway.²⁰² When support is made explicit, this separation between utility funds and governmental funds becomes less distinct and legislative appropriation becomes possible.

Some states have taken measures to minimize the risk that universal service funds will be redirected to other government programs. One measure is to express in statute that although high cost funds are held under the direction of government officials, they are not governmental funds and are not subject to appropriation. While a future legislature could repeal such a law, such a statute creates at least a moral obligation to maintain the distinction between ratepayer-generated funds and tax-generated funds. A second common measure is to place the funds in the custody of an independent third party or "fiscal agent" that manages the fund's banking functions, including collecting revenues and writing checks for funded programs.

For financial reporting purposes, states cannot fully control the boundary between public and private funds. The Governmental Accounting Standards Board (GASB) defines how states must report their financial transactions, as well as which activities and programs comprise part of the state "financial reporting entity." GASB has required one state to include its universal service fund in the state's consolidated financial reports.²⁰³ When universal service funds and tax funds are reported together and are both held in the custody of an agent of the state, legislatures are more likely to view the universal service funds as subject to appropriation for any purpose.²⁰⁴

B. Legislative authority

If a state commission decides to establish a high cost fund, a key issue is whether to seek explicit legislative authorization. Most states with high cost funds have relied on legislation to establish the basic structure of their funds.

State legislation can also help address some thorny legal issues that might otherwise limit a state fund's scope or operation. A law can address more definitively the issues of fund custody, audits and accountability. A law in most cases will be essential to mandate contribution from unregulated service providers, which in many states include wireless and VoIP providers, as well as prepaid service providers.

²⁰² There are certainly cases where legislatures have required utilities to act in support of public schools or to take actions that reduce the public cost of maintaining highways. Nevertheless, these legislative enactments are usually expressed as impositions of duty on the utility rather than as an appropriation of utility funds.

²⁰³ See generally, Government Accounting Standards Board, *Statement No. 14: The Financial Reporting Entity* (issued 1991). Vermont received such an opinion in 1996.

²⁰⁴ For example, the Vermont legislature in later years appropriated a portion of that state's universal service fund balance for other governmental purposes.

A statute can also be useful if the state decides to impose a surcharge on interstate service, a subject discussed more fully in Appendix D. If the collection mechanism is challenged under federal law, a state fund that is based on state statute has additional defenses available.

C. Setting goals

Once a state has decided to establish a high cost program, the first step should be to define the program's goals. Historically, the goals of state programs have been non-quantitative. They are sometimes defined by long multi-point lists with complex syntax. Non-quantitative goals are useful in describing what a high cost fund wishes to achieve, but it can be difficult to determine later whether these goals are actually being met and whether the benefits of the program justify the cost.

Quantifiable goals have several uses. During the design phase, quantifiable goals can help identify the most appropriate distribution mode. They can also help the state select the most appropriate sources of revenue. Once the program is in operation, clear goals are essential for program evaluation. A state preparing to establish a high cost fund should consider adopting goals in one or more of the following dimensions.

1. **Availability.** A goal might state that "service is available to all customers within ten miles of every central office." Another choice is that "service is available to 98% of all households in the state." An availability goal would also be useful to a state that wants to promote broadband deployment.
2. **Penetration.** While availability determines whether services are physically accessible to subscribers, penetration rates measure whether subscribers are actually taking advantage of those services. Penetration rates are also indicative of the availability and affordability of service. A goal might state that "95% of households subscribe to basic telecommunication service." Penetration is commonly measured by the ratio of households with either wireline or wireless service.
3. **Affordable Rates.** A goal might be "that no local exchange rates are more than 130% of the statewide average rate."
4. **Revenue Protection.** A goal might be that existing carriers not suffer revenue loss from an episode of rate revision. An example of a quantifiable goal is "to ensure that no carrier suffers a revenue loss of more than \$1.00 per line as a result of access rate revisions ordered in 2010."
5. **COLR survival.** No state has expressed the continued survival of ILECs as a statutory goal. Some states might even perceive such an express goal as a violation of the principle of competitive neutrality. Nevertheless, we have

found that the survival of ILECs—or in some states COLRs²⁰⁵—has often been a central goal of state high cost funds. Many states limit support eligibility solely or principally to ILECs,²⁰⁶ and many states calculate support amounts based on the costs and revenues of ILECs.²⁰⁷

6. **Fund Efficiency.** Like any public program, a high cost program should not generate and distribute funds unnecessarily. The principle of efficiency has led some states to adopt floors for local rates.²⁰⁸ Another possible mechanism based on efficiency would be to limit investment or expenditures by category.²⁰⁹

D. Defining supported services, providers, and facilities

A state with a high cost fund must determine which carriers will receive (or benefit from) high cost support. If the state is primarily concerned with maintaining the viability of the ILECs in that state, or only rural ILECs, it may decide explicitly to support only those carriers.

The alternative is to establish a list of prerequisites for qualifying carriers and a designation procedure to establish eligibility. As discussed above,²¹⁰ several states have made federal ETC designation a prerequisite to receiving state high cost support. Many states have added their own eligibility requirements, sometimes explicitly defining the concept of a “state ETC” in a way that expands on the requirements for federal designation.

A state with a designation procedure needs a list of criteria. This can include a list of “supported services,” possibly comprising a variation of the nine services listed by the FCC. Some states call this list a “basic services” list. Whatever the title, it usually describes the minimal features and components of local exchange service.

²⁰⁵ Nebraska provides high cost support to only one facilities-based network in a given support area. This Nebraska formulation ensures continued service from one carrier, while not specifically targeting benefits solely to the legacy ILEC.

²⁰⁶ In many states high cost support is available only for some or all ILECs.

²⁰⁷ In nearly all states, the distribution calculation is based primarily on either holding ILECs harmless or using a cost-based method that provides them with enough revenue to operate.

²⁰⁸ If a state decided that affordable residential service costs \$20.00 per month, then a goal would be “to support carriers as though they received subscriber revenues of at least \$20 per month for local service.”

²⁰⁹ For example, the HCL program limits corporate operations expense.

²¹⁰ See section IV.D.

The state should also consider whether to include broadband in any list. In the future, customers in areas served by broadband are likely to purchase voice services as mere add-ons to their broadband services. In that future, a voice-only high cost program would be anachronistic and could have unintended harmful effects.

Before adopting a list of basic or supported services, the state should consider whether that list will be used in other applications. In particular, as described in Table 4 above, the state should decide whether the list will define eligible carrier costs when support is being calculated and whether it will define the allowed or required uses to which carriers may apply support.

E. The distribution mechanisms

1. Support for ILECs

The state's universal service goals and the current legal and financial environment will drive its selection of the most appropriate distribution mechanism. Many states have created a high cost fund at the same time that they revised ILEC rates (most commonly access rates). In these circumstances, a hold-harmless mechanism is appealing. A state establishing a hold-harmless mechanism should decide in advance whether it anticipates adjusting support amounts over time as market behavior changes the supported carriers' subscriber counts and access minute counts.

If the state is primarily concerned with maintaining the long-term viability of the COLRs, a cost-based mechanism could be the best fit. Even if a state is anticipating an episode of access rate revision, it might still want to establish a cost-based mechanism. Several states have initially established hold-harmless programs and then shifted to cost-based systems in later years.

Hold-harmless and cost-based mechanisms can respond differently to market changes. Cost-based mechanisms tend to offset revenue changes with support. This can make ILEC survival more likely over the long term, particularly in a declining revenue environment. For the same reason, a cost-based system can lead to a larger fund size, particularly if ILECs are losing subscribers. By contrast, a hold-harmless mechanism may be insensitive to future events that might demand support increases (such as increased risk of ILEC business failure) or support decreases (such as improved technology or greater depreciation of investments). A hold-harmless mechanism is more likely to maintain a constant fund size over time.

A state that selects a cost-based mechanism faces several threshold decisions in defining the *Cost* and *Revenue* terms of the support equation. One is whether to approach the problem on an unseparated or "total company" basis or solely on an intrastate basis. A second question is whether to use embedded and/or forward-looking cost methods. A related question is the scale at which costs will be measured, whether study area, wire center area, or even smaller. Third, the state should decide how to treat broadband costs, including common facilities. A state with a cost-based mechanism should also anticipate the methods and frequency with which support amounts will be recalculated. If the state decides to use a cost model, it should anticipate

whether it will periodically update that model and its inputs, such as population locations and the cost of labor and materials.

In a cost-based mechanism, the revenue term requires decisions about what kinds of revenue should be considered. A state should decide whether to consider revenue from unregulated operations that use common facilities, including Internet-related revenues from affiliated DSL providers and video providers.

Table 8 summarizes the principal considerations in designing a cost-based mechanism.²¹¹

Table 8. Adjustments to Cost-based Support

Adjustment class	Adjustment	Reason	Used in
Cost			
	Return on Investment	Avoids subsidizing profits above prescribed levels.	Most states
	Broadband	Create or avoid ILEC incentive to upgrade facilities to broadband quality	
Revenue			
	Floors for residential and business monthly rates	Avoid subsidizing very low local rates	Arkansas, Maine, Nebraska
	State subscriber line charge	Comprehensively measure all subscriber-paid revenues	
	Intrastate special access revenues	Avoid double recovery of special access revenues generated by the supported network.	
	Inter-carrier net revenues	Avoid double recovery of intrastate access and reciprocal compensation revenues generated by the supported network.	Nebraska
	Federal universal service revenues for intrastate costs (HCL, LSS, High Cost Model Support)	Avoid double recovery of intrastate costs already supported by federal programs	Arkansas (small carriers), Nebraska
	DSL revenues	Avoid double recovery of costs for network facilities shared with Internet services	
	Nonregulated ISP and video revenues	Avoid double recovery of costs for network facilities shared with nonregulated activities	

²¹¹ See section V.B.

Adjustment class	Adjustment	Reason	Used in
Additional adjustments if <i>Cost</i> includes unseparated interstate cost			
First alternative – decrease <i>Cost</i>	Allocate a portion of unseparated costs to interstate	Avoid double recovery of interstate-separated costs.	Oregon
Second alternative – increase <i>Revenue</i>	Federal subscriber line charge		Nebraska
	Interstate special access revenues		
	Intercarrier net interstate revenues		
	Federal universal service revenues for interstate costs (IAS, ICLS)		

If the state is primarily interested in managing retail customer rates, a bill credit mechanism may be most useful. This method largely ignores many of the complex questions raised by cost-based mechanisms. In bill credit mode, the only question is the rate itself. It does not matter how those rates were established. For this reason bill credit mode can be particularly useful where a state has reduced or eliminated regulation of ILEC intrastate rates. Moreover, it insulates customers if a state's deregulation decision produces unforeseen rate increases. Even if competition does not discipline rates, affordability is still protected.

Bill credit mode can be attractive to new local exchange competitors. First, it seems competitively neutral, since the same rules can be applied equally to ILECs and to competitors. Second, it can entitle a new entrant to support while avoiding an intrusive cost review.²¹² Third, it provides support to ILECs only when those ILECs actually have high rates. ILEC's with low rates therefore cannot use universal service subsidies to block competitive entry.

The disadvantage of bill credit mode is that by reducing the customer's net cost, it could encourage rate increases. Bill credit mode only works if rates are restrained by some external force, either rate regulation or market discipline. If external discipline is in doubt, the state might support only a percentage of the amount by which the consumer's bill exceeds the state's target or benchmark rate.

²¹² To avoid possible abuse of the program by competitors that are not subject to rate regulation, the state might authorize a marginal credit at less than 100% of the marginal rate. In Wisconsin, for example, as rates increase above the rate threshold, the marginal credit first covers 50%, then 75%, then 85%, then 95% of the incremental rate.

A state might consider developing a reverse auction mechanism if it is concerned about promoting competition and eliminating possibly excessive subsidies to ILECs. The FCC and two state commissions have expressed interest in using auctions, but no universal service auctions have yet occurred, even on a trial basis.

2. Support for competitors

Where a state offers hold-harmless or cost-based support to ILECs and also offers support to competitive carriers, it needs a method to calculate support to the competitor. As discussed above,²¹³ there are two principal options:

1. Support can be based on the competitive carrier's own cost. This requires a method to estimate those costs and may involve recordkeeping and procedures similar to those used for incumbent carriers. Maine has adopted this plan, but no competitive carrier in Maine has applied for support.
2. The Identical Support Rule. This rule provides the same level of support (per line) to competitive carriers as is provided to incumbent carriers serving the same location. Disadvantages with this method were discussed above.²¹⁴

3. Controls over fund size

High cost programs have earned a reputation for growing beyond their creators' expectations. Today, several state commissions that operate high cost funds are seeking ways to limit the growth of their fund or to reduce its size. A state contemplating a new fund should consider whether to establish any limits on future fund size.

A spending cap is one approach to limiting fund size. This can be defined as a limitation on fund expenditures or it can be achieved by limiting the surcharge rate.

A second approach is to schedule periodic reviews of the high cost program. A more aggressive variant is to establish a "sunset" date at which a high cost fund would lapse unless positively reenacted. An impending sunset deadline can prompt a future commission to conduct a comprehensive program evaluation. It also allows the commission to create a fund while limiting expectations that it will operate indefinitely without serious review.

²¹³ See section V.E.

²¹⁴ See section V.E.

F. The collection mechanism

The task of raising high cost funds presents an array of complex issues.

1. Contributors to the fund

A threshold question is which categories of service providers should be required to contribute to the fund. In general, states will be likely to require ILECs, wireline CLECs and IXCs to contribute.

States with *ad valorem* surcharges should exempt wholesale payments between carriers from high cost surcharges. This exemption maintains competitive neutrality as between vertically integrated providers and providers who purchase upstream component services. One way to exempt wholesale transactions is to apply the surcharge only to "end-user retail telecommunications service" sales or revenues.²¹⁵

States should decide whether wireless carriers, fixed VoIP, and nomadic VoIP providers will be required to contribute. It can be helpful to simultaneously decide what kinds of registrations or certifications the state can require of these carriers.

States should decide how to treat prepaid services sold at retail by entities that are not telecommunications service providers, such as discount stores and convenience stores. If the state surcharge is applied to customer purchases, the state should consider defining the relevant sale as occurring between the telecommunications service provider and the retail outlet. If the state surcharge is applied to the revenue of the service provider, the state should consider defining that provider as the underlying telecommunications service provider. If the state applies a surcharge only to intrastate telecommunications services, it should consider prescribing a safe harbor percentage that carriers can use to eliminate interstate usage.

Some states have experienced difficulty in having prepaid wireless providers collect and remit state universal service fund surcharges because they do not send a monthly bill to their customers. States should consider alternative collections mechanisms that a prepaid telecommunications service provider can use to collect and remit surcharges on applicable telecommunications services.

States should consider whether to adopt other traditional exemptions. These can include: (1) coin-sent paid telephone calls (coin-in-box); (2) usage charges for coin-operated pay telephones; (3) paging and dispatch services; and (4) institutional providers such as hotels, hospitals, and universities while serving their own customers.²¹⁶

²¹⁵ See, e.g., 52 Pa. Code § 63.165(a).

²¹⁶ Texas collects surcharges from approximately 700 hotels and motels in that state, but is considering creating an exemption for these providers.

States should also decide whether to adopt a *de minimis* exception that exempts either small sellers with little revenue or those with small surcharge collections.

Finally, states should consider how they will administer their collection duties, including what data sources they will use to identify contributors.

2. Surcharging customers or carriers

Where a state adopts an *ad valorem* surcharge, it must decide whether to impose the surcharge on carrier revenues or customer bills. As noted above,²¹⁷ the states are currently divided on this question. One approach imposes the surcharge on customer retail bills, in the same manner as sales taxes. The alternative approach imposes the surcharge on the carrier's or provider's revenue.

Where a state imposes a surcharge on the carrier, it should also decide whether carriers will be allowed to, required to, or prohibited from passing through the surcharge as line items on retail bills. If line items are allowed or required, the state should prescribe how the line item amount will be calculated and described. The commission should also consider establishing a procedure to review the accuracy of these line-item calculations.

The FCC uses a net revenue surcharge. As explained above,²¹⁸ this option allows the rate shown in a retail line item surcharge to be the same as the rate imposed on carrier revenues.

Although many states allow line-item pass-through, customers seldom see a corresponding benefit from high cost programs. In most states support is paid to the carrier and used as general revenue. The support probably reduces rates, but the effect is indirect and does not appear explicitly on customer bills. This imbalance between the apparent cost and the apparent benefit of a high cost program can bias the public against high cost programs. One approach to rectifying this imbalance is to allow the surcharge to appear on customer bills and to require explicit credits that reflect support received. The alternative is to make both transactions implicit by prohibiting the pass-through of a gross revenue surcharge and allowing the carrier to use high cost support invisibly to reduce its own rates.

3. Intrastate and interstate

A state that imposes an *ad valorem* surcharge should decide whether to impose that surcharge on all telecommunications services or only on intrastate telecommunications services.

²¹⁷ See section V.D.

²¹⁸ See section V.D.3.

As noted above,²¹⁹ most states derive fund revenue solely from intrastate services. The advantages and disadvantages of each approach are discussed in more detail in Appendix D.

Surcharging interstate services creates some legal risk. The practice has been declared invalid in two states and upheld in one state. A broad surcharge on all telecommunications services can simplify administration, enlarge the revenue base, reduce the rate of erosion of that base, and align universal service surcharges with any state sales taxes on telecommunications.

Where a state decides to apply a surcharge only to intrastate telecommunications services, it should consider adopting "safe harbor" percentages for these services. In general, the intrastate safe harbor percentage, when added to the interstate safe harbor percentage, should equal 100%. For example, the FCC's approved safe harbor interstate percentage for wireless is 37.1%. The complementary percentage that would apply to intrastate services is 62.9%.²²⁰ Such safe-harbor calculations avoid jurisdictional conflicts and simplify administration for carriers.

States should anticipate how frequently they will adjust contribution rates. Some states perform this calculation annually or as needed to meet spending obligations.

4. Collections enforcement

When state high cost funds first came into existence, collecting revenue was a relatively simple matter. Fund revenues came from certificated carriers that had long-term relationships with state commissions. The commissions knew which carriers should be making payments. The commissions could audit the books of any of those carriers.

Today the situation has changed dramatically. Many more providers make payments into universal service funds. Many of these providers have little or no continuing relationship with the state commission. The task of collecting universal service payments has become much more like the task of collecting sales taxes. The collection agency needs suitable tools to deal with a wide variety of contributors.

State tax agencies have evolved specialized tools that increase the efficiency of their collection efforts. State legislatures should consider offering similar powers to any state commission that it authorizes to operate a universal service fund. These include:

- Authority to make an administrative determination of liability and the ability to assert that determination in court as presumably correct.
- Authority to hear appeals on liability determinations in an administrative setting.

²¹⁹ See section VI.B.

²²⁰ See <http://www.fcc.gov/Forms/Form499-A/499a-2008.pdf> at 14.

- Authority to impose penalties for late payments or nonpayment, including financial penalties and revocation of authority to operate in the state as a telecommunications service provider.
- Authority to impose and record liens on the property of delinquent taxpayers.
- Authority to bring civil suits to collect delinquencies and collect funds.

G. Administration

States should decide who will administer the collections and disbursements for any high cost program. As discussed above,²²¹ there are three basic choices: self-administration, industry administration, and third-party administration.

Self-administration means that a state administers its own program, using one or more agencies. This method can generate synergies with other regulatory activities. For example, where a commission staff member has become familiar with a particular carrier during a rate case, that knowledge could be valuable in determining the proper amount of universal service support.

Self-administration also can improve physical control of the funds. A state should consider giving custody of funds to the state treasurer or another official who handles the state's other funds. This minimizes the risk of program disruption and fund loss that could arise if there were a bankruptcy or bank failure.

Self-administration probably makes it more likely that universal service funds will be treated by the state legislature as public funds. It becomes harder to maintain the distinction between universal service funds and state funds generated by taxes when the funds are held by the State Treasurer or another agency.

The second method is industry administration. In this method, the state assigns administration to an ILEC or an industry coalition organization. This method allows maximum input and control by the carriers and providers most immediately affected by a high cost program.

Industry administration can be difficult because no existing industry group is likely to be seen as impartial. Most existing groups serve one industry sector. Allowing ILECs to administer programs, for example, can make IXC and CLECs uncomfortable.

The third method is to select or create a third-party administrator. This method allows the state to obtain independent checks on its own work and improve internal controls over accounting matters. Also, much of the work of a fund administration is to collect revenues for the fund. Third parties are likely to have more expertise than state staff on such tasks, including

²²¹ See section VII.A.

identifying delinquent carriers and applying collection methods, which have become much more complex in the last two decades.

A variation on the third method is to form a single-purpose corporation to serve as administrator. This method permits close frequent collaboration between agency staff, the administrator, and an advisory board that includes industry participants. Such a high level of interaction can raise the overhead cost, however.

It is possible to adopt one method of administration for some functions and a different method for other functions. For example, a state commission might itself calculate support amounts to be paid to carriers, but delegate to a third party the routine tasks of collecting fund contributions and writing disbursement checks.

Among states that use a third-party administrator as fund custodian, a few require a bond. A bond should be sufficient to protect the state against misappropriation of funds. The amount should be at least as large as the largest likely fund balance, possibly as large as the fund's cash flow during a particular period.

States that use a third-party administrator should also specify procedures to ensure a smooth transition whenever the administrator changes. The outgoing administrator should have a clearly defined contractual duty to cooperate with the incoming administrator, including providing copies of all written policies and procedures, as well as providing all data files in a common format.

Finally, third party administrators should be audited. Some states include high cost funds in their consolidated financial reporting. In those states, the audit should be performed according to government audit standards.

H. Accountability and evaluation

1. Program accountability

High cost funds are often large programs. As noted above,²²² states can help ensure that these programs are useful by establishing specific, measurable goals. States should conduct periodic evaluations to determine how well fund goals are being met. If a specific penetration rate is established as a goal for a high cost fund, regular monitoring of the attained penetration rate can signal how well the fund is meeting its goals.

2. Carrier accountability

States should establish clear expectations about how carriers should behave. Fund collection is one important area of accountability. Carriers should be required to collect and remit universal service payments in accord with law. Some states will also want to prescribe the

²²² See section VIII.C.

form of any line items on customer bills. A state with a universal service fund should establish a system of periodic selective audits to ensure carrier compliance with fund collection duties.

A second area of accountability is to ensure that supported carriers continuously offer satisfactory telecommunications services. Before distributing funds, a state should define those continuing service expectations, and it should establish a process for either periodic review (or audits) of compliance. It should also establish a process for handling complaints from customers who contend their service is inadequate.

A state might want also want to limit the allowed uses of support. While conceptually appealing, this step presents two difficulties. First, it requires the state to differentiate between allowed and disallowed expenditures. This can be a complex and even arbitrary task because most network investments are for facilities that are used in common by supported and unsupported services. A list of disallowed expenditures can also have unintended effects that delay the construction of advanced facilities. Second, the state must require carriers to trace their support dollars from their initial deposit into the carrier's bank account through the budgeting process and to ultimate expenditure. Dollar tracing is a difficult process at best, and many view it as meaningless. With these cautions in mind, before it distributes any high cost support, a state should decide whether it expects carriers to use support in particular ways, and if so, how carriers will demonstrate compliance.²²³

²²³ Federal law imposes a use limitation on federal support. Subsection 254(e) of federal law requires that federal high cost support be used "*only* for the provision, maintenance, and upgrading of facilities and services for which the support is intended." 47 U.S.C. § 254(e) (emphasis added). To implement this statute, the FCC requires state commissions annually to certify that ETCs in their states meet this standard. 47 C.F.R. §§ 54.313, 54.314. The FCC offers states little guidance on how to view investments in common facilities or to perform dollar tracing. At the same time, states have a strong incentive to grant certifications because a failure to certify would stop the flow of federal support. Therefore, while this annual certification process creates a formal record of compliance with subsection 254(e), it remains unclear whether and how it actually constrains how supported carriers use federal support funds.

IX. Conclusion

State commissions have long sought to provide their states' consumers with ubiquitous service, high penetration rates, and reasonable monthly bills. They have used a variety of techniques for this purpose. Competition has weakened some of those tools, particularly those involving implicit support drawn from groups subject to competition. More than 20 states have addressed this problem by creating high cost funds to provide explicit support, mostly supported by surcharges on intrastate telecommunications services.

The high cost funding issue has been sharpened by a variety of new developments. Traditional implicit support flows that weakened in the 1990s are now eroding rapidly. Although competition for local exchange service has been the law of the land for 14 years, recent technological advances and shifts in consumer behavior have sharpened the issue of how service will be financed in high-cost areas. Millions of customers have now abandoned landline service altogether, and competitors are now gaining substantial market shares in areas overbuilt for cable television or other broadband facilities.

These forces have increased the demand for state high cost funding. At the same time, Congress, the FCC, and the federal courts have constrained the states' ability to raise funds for universal service and have imposed limitations on how support can be expended. The problem facing state commissions is more urgent and complex than ever before. The authors hope that this report serves to guide state commissions and legislatures toward sound decisions about whether to establish a high cost fund and how best to design and operate such a high cost support mechanism.

Appendix A – Summary of Steps to Establish a High Cost Fund

Major Question	Considerations
Is a fund needed?	Environmental factors including competition, cost structures, revenue trends. Is it important to make the urban-to-rural support flow explicit? At what scale? Are alternatives adequate? Does an explicit fund create new risks?
Is there legal authority for a fund?	
What are the fund's goals?	
What services, providers and facilities should be supported?	ILECs only? Rural ILECs only? Facilities-based carriers? Carriers with COLR-like obligations? How will eligible carriers be identified? Through a designation proceeding? How does federal ETC designation affect eligibility?
What distribution mechanism is best?	What is the best mechanism for ILECs: Hold-harmless, cost-based, bill credit, or auction? What is the best mechanism for competitors: cost-based or Identical Support Rule?
Are controls needed over fund size?	Is there a need for a cap? A sunset review?
How will funds be collected?	<i>Ad valorem</i> surcharge? Per-line surcharge? Will an <i>ad valorem</i> surcharge be on all retail revenue or just intrastate? On the buyer's purchase or the seller's gross revenue? Should wireless, VoIP, prepaid phones and cards contribute? What services or sellers should be exempt? Are special collection mechanism needed for some services? What enforcement
Who will administer the fund?	State employees or third-party administrator? One for some functions and the other for other functions?
How will the fund be evaluated and made accountable for results?	Should there be a schedule for evaluations? Auditing of contributors and recipients?

Appendix B –Overview of State High Cost Funds

Alaska

Alaska's universal service fund (AUSF) was established in 1999. It has three components: (1) public interest payphone support; (2) intrastate local switching support, also known as dial equipment minutes (DEM) weighting support; and (3) state Lifeline support. In Fiscal Year 2007-2008, the total size of the AUSF was about \$4.2 million, including about \$100,000 for payphone support, \$1.63 million for intrastate local switching, and \$2.4 million for state Lifeline. The AUSF is administered by a third party: the Alaska Universal Service Administrative Company.

To support AUSF, all registered or certified carriers that provide intrastate telecommunications services must pay a surcharge on their annual intrastate gross end user revenues (see 3 AAC 53.340 for applicable services for AUSF contribution). The latest surcharge of 1.05% was effective January 10, 2009. Any company that has an annual contribution payment less than \$100 is exempt from the payment. Companies may recover the state USF surcharge as a line item on customers' bills, but are not required to do so.

The Regulatory Commission of Alaska (RCA) designates ETCs for the purpose of receiving federal USF as well as state Lifeline support. The state just passed requirements on ETC designation and annual certification on June 8, 2009 (3 AAC §§ 53.400 – 499). To date, state support for payphone and local switching has only been received by ILEC ETCs.

The AUSF provides intrastate DEM support and has done so for nearly two decades. DEM support had been an implicit subsidy, but is now an explicit support amount that is determined during state access charge proceedings. The AUSF mirrors the federal DEM weighting rules that were in effect in 1988 and replicates the federal procedure for determining federal support for local switching, with a minor exception allowing for additional support for companies with small exchanges. At the federal level, the interstate portion of dial equipment minutes (DEM) is more heavily weighted for smaller ILECs. As a result, a greater proportion of local switching costs are recovered from the interstate jurisdiction for these smaller companies. The AUSF mirrors this process, but instead of separating costs between state and interstate, the state process separates costs between local and intrastate toll. As a result, Alaska ILECs go through two separations "divisions." The first separations division separates costs between state and interstate under 47 CFR Part 36, and the second process separates the intrastate costs between local and intrastate toll. For the ILEC's switching investment (Category 3 investment), the interstate portion is recovered through interstate access charges (i.e., federal switching charges) and federal local switching support.

The ILEC's intrastate switching costs are recovered through local and intrastate access revenues, and, for some small ILECs, through state DEM support. The AUSF DEM support is designed to lessen the amount of local switching investment that is allocated to local rates. In other words, state DEM support reduces the local portion of intrastate switching costs.

To determine the state DEM support level, a weighting factor is applied to the intrastate toll percentage to increase its share of the total intrastate costs. The weighting factors are assigned as follows:

Study area with 0-10,000 lines	3.0
Study area with 10,001-20,000 lines	2.5
Study area with 20,001 lines or above	1.0

The separations process for the intrastate costs is in concept run twice: once using the DEM weighting factors as noted above and then without the DEM weighting. The DEM support is the difference between these two separations calculations.

ILECs can recover their Category 3 investment through a combination of interstate access charges, federal local switching support, intrastate access charges and state DEM support up to a capped percentage. At the federal level, federal access charge and local switching support is capped at 85%. The AUSF applies this same cap, limiting the total local switching support that most ILECs can get from all sources—federal, state and AUSF—to 85%. For ILECs with exchanges that provide toll free calling to fewer than 100 access lines, the cap may rise to 90% depending upon the percentage of small exchanges. ILECs that are at the 85% to 90% cap recover the remaining switching costs (10-15%) from local rates.

Currently, AUSF support for intrastate DEM is relatively small. Only three small ILECs qualify for support. This is in part due to the large number of ILECs that qualify for federal local switching support at the 85% cap level.

Alaska is unique in telecommunications regulation due to the high-cost nature of its infrastructure. Only ACS of Anchorage, Inc. is considered a non-rural ILEC. Alaska intrastate access charge rates are relatively high, around .065 cents per minute per originating or terminating end on average. The intrastate access revenue is between \$40-60 million per year. ILECs assess a high carrier common line charge (CCLC) on intrastate access minutes. CLECs are allowed to charge access rates up to the ILECs' level. An ILEC's CCLC revenue is evaluated every other year, if it remains in the state access charge pool. If the ILEC faces no competition, it continues to participate in the state access pool. Once the ILEC faces competition, it exits the pool and bills stand alone access charges. When the ILEC faces competition, it effectively splits the access revenues with its competitors, based on their relative market shares.

In the past, the Alaska commission opened a docket on local rate affordability. However, it was difficult to determine affordability standards given various intervening factors. The commission did not conclude that current rates were unaffordable and that additional state funding was necessary to reduce local rates. By state regulation, an ILEC may propose to deaverage its local rates at the exchange level. Only a few ILECs have petitioned to do so. Recently, two ILECs petitioned to deaverage their local rates, and implemented different sets of rates for its competitive and non-competitive markets. Copper Valley Telephone Company successfully obtained deregulatory election through customer ballots. It no longer files local tariffs with the commission.

The RCA has an ongoing proceeding that addresses future access charge and state USF reform. The commission is considering reductions in the state CCLC with associated support for loop costs to be covered by the AUSF. Commission staff estimates that if the CCLC were to be eliminated, local rates in some areas would increase to very high levels, as much as \$90, without additional state subsidy; on the other hand, to provide a subsidy to offset the potential local rate increases, the size of the AUSF would need to be substantially expanded.

References:

3 AAC §§ 48.430. Jurisdictional Separations.

3 AAC §§ 53.300-399, Universal Service Fund.

Regulatory Commission of Alaska. 2009. Order Inviting Comments on Proposed Regulations, Docket R-08-003(2), dated February 27, 2009.

Arizona

The Arizona fund (which is called the Arizona Universal Service Fund) has been functioning since 1989. The fund was established in response to the ending of the state toll settlements process, and was created by the Arizona Corporation Commission under the authority of the Arizona Administrative Code.

Support from the fund is determined by subtracting the benchmark rates for basic local exchange telephone service from the cost of providing that service, and adjusting for any federal universal service support:

Support = Cost *less* revenue from benchmark local rates *less* federal universal service

For companies that are designated as small (fewer than 20,000 access lines) and intermediate (greater than 20,000 and fewer than 200,000 lines), cost is determined through an embedded cost study. For large local exchange carriers, cost would be determined using Total Service Long Run Incremental Cost principles. Specific benchmark local rates are determined by the Commission for each carrier. In the case of the one carrier currently receiving support, the Commission required the carrier to increase its local rate from \$10.00 to its benchmark rate of \$15.00 per month.

All providers of basic local exchange telephone service are eligible to apply for support from the fund by making a formal request, filing rate case information, and providing a statement of need to the Commission. The commission then performs a rate evaluation, including the determination of the appropriate benchmark rate, to determine whether any support is needed. However, since the establishment of the fund, only one ILEC has applied and received support. The support level for that carrier (approximately \$770,000 per year) was established in 1989 and has not been changed. To date, one carrier has also asked for assistance in extending service to an un-served area; the Commission authorized the carrier to recover some of its costs from the fund.

The Arizona fund follows the identical support rule. CLECs providing service in an area in which the ILEC is receiving support are eligible to receive the same level of support per customer as the ILEC receives. The ILEC's level of support would be decreased accordingly. To date, no CLEC has come forward to request support.

All telecommunications service providers, including wireless service providers, contribute to the Arizona fund. VoIP providers do not contribute. Half of the contributions to the fund are made by local telephone companies, wireless providers, and other providers that connect to the PSTN; these providers are called Category 1 contributors. Payments from Category 1 providers are on a per-line or per-trunk basis, with one trunk equivalent calculated at 10 access lines. The other half of the contributions to the fund are made by intrastate toll providers. These providers are called Category 2 providers and their contributions are assessed as a percentage of intrastate toll revenue. Carriers who provide both local telephone service and toll (Qwest for example) pay contributions as both Category 1 and Category 2 providers. In

2009, the per-line rate for Category 1 providers was raised from \$0.003808 (\$0.038085 per trunk connection) to \$0.006471 per-line and \$0.064714 per trunk. The surcharge for Category 2 providers was raised from 0.1781 percent to 0.2485 percent. Category 1 and Category 2 contributors are allowed to recover their contributions through a line item on their customers' bills.

The future of the Arizona fund is now under consideration by the Arizona Corporation Commission. The Commission has opened a docket to consider possible comprehensive revisions to the fund and has linked the issue with access charge reform by combining the docket with an existing access charge docket.

References

Arizona Universal Service Fund Rules, A.A.C. R14-2-1201—R14-2-1217

Docket No. RT-00000H-97-0137, Decision 70659

Combined Docket: RT-00000H-97-0137 & T-00000D-00-0672

Arkansas

Arkansas's high cost fund (HCF) evolved from the original Arkansas universal service fund (AUSF). The AUSF was created by statute in 1997 and served as a revenue replacement mechanism, Rural ILECs could recover revenue shortfalls due to a variety of causes including intrastate access charge reductions, educational projects, court-related activities, and decreases in federal universal service fund support. The AUSF grew rapidly in size. AT&T, which was not eligible for support, filed a formal complaint against the AUSF. The complaint resulted in a settlement in which each carrier agreed to a prescribed level of support on an interim basis until a new fund could be created. That new fund, the Arkansas High Cost Fund (AHCF), was created in 2007 by Arkansas Act 385. All categories of ILECs are eligible to apply for support from the AHCF.

The 2007 Act created a fund of \$3 million to help carriers serving fewer than 15,000 lines through the transition to the new AHCF. The transitional fund provides for a 60-month phase-in. During this period small carriers receive a declining proportion of the difference between the higher support levels from the old AUSF and the lower support levels from the new AHCF.

The total AHCF is capped at \$22 million annually, including administrative costs. Both wireline and wireless carriers are required to contribute to the fund via an intrastate revenue surcharge. Wireless carriers are allowed to use the complement of the federal safe harbor percentage to determine their intrastate revenue. VoIP providers do not directly contribute to the fund; however the Arkansas Public Service Commission is considering whether to require them to become contributors. Some VoIP providers have CLEC affiliates who do contribute to the fund. CLECs and wireless carriers are not eligible for funding from the AHCF, although they are eligible to apply for federal ETC status, which would entitle them to receive federal high cost support.

Contributions to the fund are made through surcharges on retail receipts. The fund administrator adjusts the surcharge rate on an as-needed basis. The surcharge began at 0.70% in 2007. The rate was increased to 1.65% in June of 2009 largely in response to the FCC's decision to increase the interstate safe harbor percentage for wireless carriers. That federal change reduced the intrastate contribution base and produced a 30% drop in reported revenues. The rate will increase to 1.75% for 2010 because of the continuing decline in revenues reported by the fund contributors. The administrator may levy a late payment penalty if a carrier fails to contribute to the AHCF. Continued nonpayment could result in a carrier's loss of certification.

The AHCF provides support to four categories of carriers. It is rare for any individual carrier to move across categories (with the exception of merger or divestiture events):

Category I: AT&T is the only carrier in this category. Total disbursements for this category are made based on the FCC's synthesis model and are capped at 13.5% of the total AHCF.

Category II: The CenturyTel properties in the state are the only carriers in this category. Total disbursements are capped at 13.5% of the total AHCF.

Category III: Windstream is the only carrier in this category. Total disbursements are capped at 2% of the total AHCF.

Category IV: ILECs with fewer than 15,000 access lines. Total disbursements are capped at 71% of the total AHCF.

Funding for AT&T is based on cost outputs from the federal high cost model. Support is provided only for AT&T wire centers that serve fewer than 3,000 lines. The per-line state support equals AT&T's average monthly per-line cost less the FCC cost model benchmark. The AHCF administrator has access to the FCC's high cost proxy model outputs for Arkansas and monitors that data for any changes that might influence AT&T's state support. As long as AT&T's calculated cost-based support exceeds or equals the capped amount of its AHCF (13.5% of \$22 Million) AT&T receives the capped amount. As of June 2009, AT&T was receiving capped AHCF.

The other three categories of carriers (state ETCs with fewer than 500,000 access lines) are considered rural carriers. Their AHCF support has two components: high cost loop support and local switching support. Each is calculated by using study-area-level data that ILECs submit to NECA and that are used by USAC to calculate federal high cost fund support.

Each carrier's state loop support (its "loop support element") is equal to the carrier's annual unseparated unlimited local loop revenue requirement as reported to NECA, minus any per-loop federal high cost support received by the carrier, minus \$344.40.

The \$344.40 figure is a statutory benchmark that corresponds to the national average annual cost per loop calculated by NECA in 2005. The Arkansas legislature determined that \$344.40, or \$28.70 per line per month, is the amount that the carriers should be able to recover from local rates and other associated revenues. The carrier's uncapped state local loop support is determined by multiplying the local support element by the carrier's year-end total number of loops.

The AHCF also provides Local Switching Support (LSS) for the non traffic sensitive portion of local switching costs. Support is calculated at 15% of the carrier's total local switching revenue requirement, as reported to USAC.

After summing the uncapped support amounts for Category II, III, and IV carriers, the fund administrator then applies the caps. Where a cap applies, each carrier within that category has its support reduced proportionately. As noted above, carriers with fewer than 15,000 lines also receive transitional support during a 60-month period. The difference between the 2007 settlement amount and the calculated AHCF support is calculated, and eligible carriers receive a declining portion of the difference.

The state fund administrator was selected through a competitive bidding process. Previously NECA administered the AUSF. Rolka Loube Saltzer Associates took over the administration contract at the beginning of 2004 and continues to administer the new AHCF. If authorized by the Commission, the administrator can conduct AHCF-related audits on specific companies. The Commission can overrule the administrator's recommendation regarding audits. The administrator's decisions regarding the level of assessment and the levels of high cost support can be appealed to the Commission.

Arkansas still maintains other mechanisms to support universal service. The Arkansas Intrastate Carrier Common Line Pool (AICCLP) still exists, and pool participants are the rural ILECs. Their pooled access rate is 1.65 cents per intrastate access minute. The AICCLP provides about \$500,000 to a fund for extension of telecommunication facilities. Although not a member of the AICCLP, AT&T occasionally receives grants from the fund to extend its facilities.

Arkansas statute explicitly promotes the use of the AHCF for broadband services. It provides that "[t]he AHCF shall be used to accelerate and promote the incremental extension and expansion of broadband services and other advanced services in rural or high-cost areas of the state beyond what would normally occur..." This statutory goal has been achieved through (1) basing AHCF support on the carriers' unseparated loop cost, without any limitation, and (2) making line extension support available for new fiber facilities that enable broadband services.

Reference:

Arkansas Administrative Code §23-17-404

<http://www.r-l-s-a.com/Arkansas/index.htm>

California

California imposes six separate mandatory surcharge rates on end-user charges for intrastate telecommunications services. These six programs are what the California Public Utilities Commission (CPUC) calls “public purpose” programs. The surcharge rates vary by program and are adjusted periodically based on the forecasted demand of the programs. In fiscal 2008, these programs collected \$665 million in funding. Four of the programs are described below, including two high cost programs for voice service.²²⁴

The older high cost program is the “A Fund” (CHCF-A). Since 1988 it has been providing support to smaller “rate of return” (ROR) carriers. Fourteen “small” carriers and three “mid-sized” carriers are eligible.²²⁵ The A Fund uses a cost-based methodology based on embedded costs. Currently, return on investment is set uniformly at 10%. Estimated carrier revenue is subtracted from cost, including both actual federal universal service support and estimated customer revenues. Carriers receive support only if their Residential Local Basic Exchange rate is at least equal to 150% of AT&T’s. Some eligible carriers decline to receive A Fund support because they prefer not to undergo rate case reviews or because they prefer not to have support calculated using the uniform ROI rate of 10%. Under a “waterfall” provision, three years after the last rate review, the CPUC reduces CHCF-A support over a term of six years to zero. This provision generally reduces or eliminates support to carriers that have not gone through a recent rate case review. The CPUC reduced the surcharge rate for the A Fund in 2008 to 0.13%.²²⁶ The A Fund budget for 2010-11 is \$57.6 million.

The newer high cost program is the “B Fund” (CHCF-B), which has operated since 1996. It provides support to the larger, non-rural carriers.²²⁷ B Fund distributions are also cost-based.

²²⁴ The remaining two programs are the Universal Lifeline Telephone Service (ULTS) program, and the “DDTP” program which supports the California Relay Service and Communications Devices Fund. As of June 1, 2008, the ULTS surcharge rate was 1.150%, and the DDTP surcharge rate was 0.20%.

²²⁵ 10 of 17 small LECs received A Fund support in 2009.

²²⁶ Before 2008, the A Fund surcharge reached 0.21%.

²²⁷ All of these carriers are now subject to the CPUC’s “Uniform Regulatory Framework” (URF) which has granted pricing flexibility for basic service rates to all of California’s larger ILECs, including AT&T, Verizon, Frontier, and SureWest. No carrier concurrently receives support from both the A and B funds. Some Frontier exchanges have moved over time from rate of return regulation to URF.

Cost is estimated by a proxy model²²⁸ that produces an estimated cost figure for each Census Block Group (CBG).²²⁹ The support mechanism calculates support for each customer based on the average cost in that customer's CBG, minus expected revenue. Expected revenue is the greater of: 1) \$36.00 per line, or 2) the sum of the carrier's fixed customer rates²³⁰ and its federal universal service revenues. The result is that any customer located in a CBG with costs above \$36 per line can generate support for that customer's carrier, except where the sum of the carrier's fixed charges and its federal support are greater than cost. Support to the carrier is the aggregate of these customer-based support amounts.

At one time, the B fund was much larger than the A Fund, generating a surcharge rate of 2.43% just for the B Fund. In 2007, the CPUC decided to revise the distribution parameters and reduced the surcharge rate to 0.25%.²³¹ In 2010-11 the B Fund budget is \$50.9 million, slightly less than the A Fund.²³²

CHCF-A and CHCF-B support is intended for carriers of last resort (COLRs).²³³ Part B funding is also available to competitive carriers that accept COLR obligations.²³⁴ In the event of an ILEC failure, therefore, a competitive carrier receiving Part B support might be required to provide service to all customers within its service territory, including areas where its service overlaps with the ILEC.

²²⁸ The cost model was the Cost Proxy Model. The model is no longer available or supported by its developer. As data used in the original model runs have aged, the CPUC has become more concerned that the model's original outputs do not reflect current settlement patterns or costs. If new proxy costs are to be developed, the HAI version 5.3 model will be used.

²²⁹ The block group is the lowest-level geographic entity for which the Census Bureau tabulates sample data from the decennial census.

²³⁰ Fixed customer charges equal the sum of the monthly service rate plus the federal End User Common Line Charge (EUCL).

²³¹ The B Fund revenue benchmark was \$20.30 in 2007 and was increased in four steps to a final level of \$36.00, which took effect on July 1, 2009.

²³² The B Fund distributed \$386 million in calendar 2007. The budget was \$419 million in FY 08-09, but because of program changes less was expended. The budget for FY 2010-11 is \$52.5 million.

²³³ CHCF-A recipients currently have exclusive landline franchises under California law, although those companies in some cases are competing with wireless carriers and cable-voice providers.

²³⁴ Cox Cablevision is the only competitive carrier currently receiving that support.

CPUC also operates a California Advanced Services Fund (CASF) program to provide matching funds for the deployment of broadband infrastructure in unserved and underserved areas in California.²³⁵ The CASF budget for 2010-11 is \$25 million. State legislation caps the lifetime revenue generated by this surcharge at \$100 million, after which the program is expected to end. The California legislature has extended this program to January 1, 2013.

The CPUC has announced that it intends replace the B Fund's cost-based distribution mechanism with a new mechanism based on a "reverse auction" process using a "market-based" approach to distribution.²³⁶ CPUC anticipates several possible advantages from auctions, including: 1) avoiding the need to repeatedly evaluate and update competing cost proxy models and their underlying cost studies, 2) technological neutrality and avoiding the need for the CPUC to determine the technology that can offer service at the lowest cost, and 3) avoiding the need for the CPUC to estimate carrier revenues from all sources, not just basic service revenues.²³⁷

The CPUC also has recognized that auctions could present potential difficulties. These include: 1) the auction might not produce any interested bidders for less desirable service areas, 2) the overall effect might be to "ratchet up" the level of subsidy in areas with the least competition,²³⁸ 3) the CPUC may not be legally able to restrict subsidy to the winning bidder, 4) following the auction, the CPUC may not be able to relieve incumbent LECs of their interconnection obligations, and 5) the CPUC might not be able to require an exiting COLR to sell facilities according to a specific pricing method. Although the CPUC first expressed interest in reverse auctions in 1996,²³⁹ it has not yet conducted any auctions, even on a pilot basis.²⁴⁰

CPUC also operates a California Teleconnect Fund (CTF) that provides a 50% discount on telecommunications services to schools, libraries, health care organizations, community

²³⁵ The CASF surcharge rate was 0.25% as of June 1, 2008.

²³⁶ CPUC, *Order Instituting Rulemaking into the Review of the California High Cost Fund B Program*, rulemaking docket 06-06-028, Decision 07-09-020 at 10, 109, at 72. In June of 2009 the CPUC opened a new rulemaking on the same topic. CPUC *Order Instituting Rulemaking into the Review of the California High Cost Fund B Program*, rulemaking docket 09-06-019, Decision of 6/23/09.

²³⁷ CPUC, *Order Instituting Rulemaking into the Review of the California High Cost Fund B Program*, rulemaking 06-06-028, Decision 07-09-020 at 10, 109, 116-17.

²³⁸ *Id.* at 114-15.

²³⁹ *See id.*, at 114.

²⁴⁰ CPUC staff determined that conditions were unsuitable in 1999. *Id.*

colleges, and community based organizations.²⁴¹ As of the end of 2008, CTF was providing subsidies to 3,330 organizations. The surcharge rate for CTF is 0.079%, and the budget for 2010-11 is \$70 million.

The CPUC sees its principal challenges as adapting existing programs to new technologies, carrier of last resort issues, and how best to keep support moderate in high-cost areas. For the A Fund, the CPUC is seeking a funding mechanism that can provide sufficient funding to allow small carriers to provide telephone service to rural communities at a reasonable price, while not overburdening ratepayers. For the B Fund, the CPUC is looking to define a technologically neutral definition of basic service as it applies to the Carrier of Last Resort.

²⁴¹ The CTF surcharge rate was 0.079% as of June 1, 2008. The program has a budget of \$46.5 million for FY 2008-09 and \$60.340 million for FY 2009-10.

Colorado

(The following discussion is based on an interview with Commission staff members; but it has not undergone a final staff review.)

The Colorado Public Utilities Commission (CPUC) has operated a state universal service fund since 1990. The current high cost program, known as the Colorado High Cost Support Mechanism (CHCSM), aims to ensure that basic telephone service is available and affordable to all citizens of the state.²⁴²

Distributions. CHCSM is provided to each "Eligible Provider" (EP). A carrier is an EP if it is designated as an Eligible Telecommunications Carrier (ETC) for federal purposes and if it demonstrates to the commission that its revenues do not exceed its cost.

Colorado statute requires that CHCSM distributions be no larger than the difference between the cost of providing local exchange service, minus "all funds" received from any source.²⁴³ CHCSM currently calculates support using three methods. One method applies to Qwest. A second method applies to smaller rural ILECs. The third applies to competitive carriers.

Qwest is Colorado's sole "non-rural" ILEC. In recent years, Qwest received 95% of all CHCSM funding distributions. The support is substantial, amounting to \$10.92 per line per month in 2008. The CPUC believes this allocation of most funds to Qwest coordinates well with federal support policies. Rural carriers receive far more federal USF support per line, and the CHCSM therefore directs the majority of its funds to Qwest. Qwest's per-line support is equal to its total unseparated cost minus a "Revenue Benchmark" and minus federal USF support.

- The CPUC uses a cost model to estimate Qwest's per-line cost at the wire center scale. The model we originally run in 1995,²⁴⁴ and it relies on some data from the early 1990s, including census data. CPUC also uses some more recent data, including line counts and carrier revenues for optional features and directory assistance.
- The function of the revenue benchmark is to avoid subsidizing any local rates that may be below the benchmark. The CPUC adjusts the revenue benchmark annually. For residential lines, the 2009 revenue benchmark was \$18.99 per line per month, an amount equal to 166% of the statewide average rate. For business

²⁴² Colo. Rev. Stats. § 40-15-5-2(3).

²⁴³ Colo. Rev. Stats. § 40-15-208(2)(a).

²⁴⁴ The model currently in use is the HAI 5.2 model, with some staff adjustments.

lines, the 2009 benchmark was \$34.79 per line per month, or 217% of the average local rate in the state.

- The CPUC also subtracts federal USF support from cost. All federal support programs are included, including those aimed at replacing lost interstate access revenues.

CHCSM also provides support to nine of approximately 28 rural carriers. Support can cover loop, switching and exchange trunk costs. The amount of support is determined at the study area level and is based on the carrier's revenue requirement, net of customer revenues.

- Using embedded cost methods, the CPUC calculates an intrastate "local service revenue requirement." In 2007, in response to legislation, the CPUC adopted "streamlined" data and analysis requirements for calculating support to rural carriers.²⁴⁵ Today, rural ILECs file a one-page annual financial filing that lists intrastate investments, revenues, and expenses.²⁴⁶
- Customer revenues are set equal to a statewide benchmark equal to 130% of the state average local service revenue requirement for non-rural carriers. This calculation generates support to high cost rural carriers while eliminating any possibility of a subsidy of low local exchange rates.
- As with the calculation for Qwest, federal support is deducted from the revenue requirement of rural carriers.

CHCSM support amounts are changed by explicit commission decision on a carrier-by-carrier basis. Both the commission and the carrier are free to seek adjustments, but adjustments have been infrequent. Most carriers have requested at least one upward adjustment. Carriers annually complete a simple single page form based on available information so that the staff can evaluate whether to seek a downward adjustment. CPUC staff has never requested a downward adjustment.

CHCSM for competitive carriers is based on the Identical Support Rule. Support is provided on a per-customer basis. The support is equal to the per-line support that would be granted to a wireline ILEC (rural or non-rural) for that same customer at the same location. In

²⁴⁵ Before 2006, the commission had conducted periodic rate cases for each carrier. The CPUC had encouraged periodic reviews by using a "phase-down" mechanism that reduced CHCSM support over a period of 7 years following a rate case.

²⁴⁶ The intrastate totals are divided among local exchange services, intrastate toll and access, and non-rate-regulated services.

areas served by rural ILECs, the rural ILEC may elect to disaggregate support. Where the rural ILEC has done so, the CHCSM support to the competitive carrier is disaggregated below the study area level.

The identical support rule is controversial. In one case, the consumer counsel challenged the funding for wireless carriers, but the CPUC's Administrative Law Judge deferred the issue to a future rulemaking. Colorado has four wireless ETCs receiving federal support. CHCSM is provided to only one of these, a carrier that provides service primarily in rural areas.

The CPUC is considering changes to the CHCSM. It issued a notice in 2008 asking such basic questions as whether CHCSM has met its goals and is still necessary. The NPRM also asked how the structure should be improved, and whether the CPUC should consider other related issues such as rate rebalancing, broadband funding, and federal funding programs.²⁴⁷

Colorado also operates other universal service programs. These include participation in the federal Lifeline Assistance and Link Up America programs and telecommunications relay services.

Collections. In 2008, CHCSM raised \$62.6 million. The contribution rate was 2.2% on intrastate revenues.²⁴⁸ Four wireless carriers currently contribute to the CHCSM, basing their contribution on 52.9% of their total retail revenues, a percentage that is the complement of the interstate safe harbor ratio published by the FCC for wireless carriers. Wireless carriers contributed 63% of all CHCSM revenues in 2008. One VoIP provider also contributes to the CHCSM. That VoIP provider contributes at 35.1% of total retail revenues, a number that is the complement of the interstate safe harbor ratio published by the FCC for VoIP. The CPUC is considering whether to require contributions from other VoIP providers.

Administration. The CPUC administers the CHCSM. This includes billing, collections and disbursements as well as collecting information on contributing entities and their revenues, projecting demand, determining revenue benchmarks used. It also includes taking enforcement action against delinquent service providers. The CHCSM funds are actually held by CenturyTel, Inc., pursuant to the terms of a Memorandum of Understanding with the CPUC.²⁴⁹ CenturyTel receives \$275,000 per year as administrative cost. The CPUC is considering appointing a third-party financial administrator.

²⁴⁷ CPUC, *Proposed Rules Relating to the Colorado High Cost Support Mechanism*, Docket No. 08R-476T, Notice of Proposed Rulemaking, Decision No. C08-1129, ¶ 15.

²⁴⁸ The CHCSM rate has been 2.2% since July 1, 2008. In early 2006, the rate was 2.9%.

²⁴⁹ Until approximately 2000, Qwest held the funds.

Idaho

The Idaho Universal Service Fund (ID USF) was established pursuant to the Idaho Telecommunications Act of 1988. The 1988 Act authorizes the Idaho Public Utilities Commission to establish and maintain a universal service fund for the purpose of sustaining the universal availability of local exchange service at reasonable rates and promoting the availability of intrastate toll services at reasonably comparable prices throughout the state.

To receive ID USF support, a carrier must first be a state Eligible Telecommunications Carrier (ETC). To qualify, the carrier's local exchange service rates must be at or above a rate benchmark that is set at 125% of the weighted statewide average line rate. The 2009 125% statewide average threshold rate is \$ 25.76 for single-party residential service and \$40.54 for business service. In addition, a qualifying carrier's intrastate access rates must be at least 100% of the statewide average.

After the first year of eligibility, if a carrier's average rate for residential, business or intrastate access service falls below the threshold, the carrier loses support if it does not increase rates to the current threshold. Minor rate differences are disregarded if the carrier's rates are less than 3% below the benchmark or the deficiency equals less than \$6,000 of revenue per year.

The ID USF is a cost-based fund in which support covers the difference between the carrier's intrastate revenue requirement and its intrastate revenue. Eligible carriers received support equal to 75% to 100% of their residual revenue requirement, after consideration of subscriber and access revenues. Current ID USF support levels were in large part determined through a 1992-1993 proceedings that involved reconfiguration of several Extended Area Service (EAS). In those proceedings, the Idaho commission enlarged local calling areas, thereby reducing intrastate long distance and access revenues. The ID USF program was modified to compensate for some of the lost revenue. The ID USF originally provided support for eight rural ILECs, and those same carriers continue to receive support today. Annual support levels have been stable since 1993.

Two non-rural ILECs (Qwest and Verizon) have recently increased their rates. Because they are large carriers, this caused an increase in statewide average rates. As a result, supported carriers in Idaho will be required to raise their local rates to the new higher statewide average benchmark or lose ID USF support under the current disbursement mechanism.

In theory, a competitive provider can be designated as a state ETC and may submit an application to receive support. However, it would have to justify the need for support through a cost study. No competitive providers have applied for funding.

ILECs, CLECs and IXC's contribute to the fund. The Idaho USF surcharge has two parts: (1) a uniform per-line surcharge on local exchange service (currently \$0.10 per month for residential lines; \$0.17 per month for business lines); and (2) a per-minute surcharge on intrastate toll minutes (currently \$0.003 per minute, including both message telephone service and wide

area telephone service). LECs and IXC's may collect these contributions either explicitly or implicitly from the end-user bills. The companies that provide local telephone service report their residential and business line counts and remit surcharges on a monthly basis unless otherwise provided by order, Commission Staff or from the Administrator. All LECs and providers of intrastate telephone services submit annual reports to the fund administrator. The contribution rates are reviewed annually and revised as necessary to meet the fund requirements. A LEC may request an exemption from monthly reporting and remittances if it serves a very small number of local service lines and so would generate a very small monthly surcharge. An intrastate service provider may request an exemption from monthly reporting and remittances if it is exclusively a reseller of intrastate services and its underlying provider is already remitting the contribution for the reseller's minutes.

Wireless providers and VoIP providers currently do not contribute to the state USF. If the FCC decides to adopt a telephone number-based contribution mechanism, the Idaho commission may consider following suit.

The ID USF collected about \$2 million in Fiscal Year 2008-2009. The fund covers both support disbursements as well as the administrative expenses of the fund. The Idaho commission appointed a third-party contractor, Ms. Alyson Anderson, to administer the fund.

References:

Idaho Administrative Code §31.46.01 Universal Service Fund Rules.

Idaho Statutes §62.610 Universal Service Fund.

Description of Idaho Universal Service Fund available at
<http://www.puc.state.id.us/telecom/usf.pdf>

Universal Service Fund Annual Report 2008, available at
http://www.puc.idaho.gov/internet/cases/tele/GNR/GNRT0803/ordnotc/20080909FINAL_ORDER_NO_30635.PDF

Illinois

The Illinois Commerce Commission was granted statutory authority in 1999 to create a high cost fund (the Universal Service Support Fund). The resulting fund has been operational since October 1, 2001.

The current statutory fund replaces an earlier fund established by the Commission in 1986. The 1986 fund aimed to mitigate the impact of a state access charge reform episode on small, rural ILECs. At the time, those ILECs faced a revenue shortfall when they reduced intrastate carrier common line charges. To avoid local rate increases higher than those of larger ILECs, the 1986 program provided small ILECs with support for high cost loops and support for non-traffic sensitive switching costs.

The 1999 statute authorized the Commission to establish a new high cost fund that would continue to provide support to these high cost carriers. To receive support from the new fund, these carriers were required to demonstrate that their economic cost of providing basic local service exceeded an affordable benchmark rate determined by the Commission.²⁵⁰ The statute gives the Commission authority to establish a separate fund to provide support to additional carriers; however, support from this fund is limited to the small high-cost ILECs receiving support from the earlier fund.²⁵¹ Thirty-nine small ILECs are currently eligible for the fund.

The commission set initial support amounts for carriers in 2001, based on cost. At that time, the Commission used both forward-looking and embedded methods to determine support. Carriers first had to demonstrate a need for support through use of the HAI cost proxy model. Then the commission used an embedded cost Rate-of-Return Analysis as a cap on the results of the HAI model and as the basis for support calculations. Support was calculated by subtracting total company revenues including federal universal service support from the carrier's intrastate revenue requirement. Intrastate revenues were set equal to an affordable benchmark local rate, rather than the actual local rate.

The Verizon rate of \$20.39 was selected as the affordable benchmark rate for residential and single line business service. Carriers were allowed during a phase-in period to raise their local rates to the benchmark level. Support payments were decreased as local rates increased to the benchmark level. Since the completion of the phase-in period, support amounts have been disbursed at a fixed amount each year.

Contributions to the fund are collected through a surcharge on intrastate retail receipts. All certificated local exchange and interexchange carriers pay the surcharge. Certificated VoIP providers, and some of the larger non-certificated fixed VoIP providers, also contribute.

²⁵⁰ 220 ILCS 5 §13-301(d)

²⁵¹ 220 ILCS 5 §13-301(e)

Nomadic VoIP providers do not. Wireless providers are exempt by statute from the Funding Carrier responsibilities.

The fund collected \$9.9 million during 2007, at which time the surcharge was 0.03461%. The rate has since been increased to 0.3638%. This increase reflects a declining intrastate revenue base. The fund is administered by the Illinois Small Company Exchange Carrier Association, which was selected by the Illinois Commerce Commission because of its expertise.

Support payments from the fund have not changed since 2001, except for the local service phase-in to the benchmark rate described above.

References:

Twenty-Seventh Interim Order, Commission Docket 83-0142, October 16, 1986

Illinois Public Utilities Act, §13-301(a) – (e) [220 ILCS 5/13-301]

Second Interim Order, Commission Docket 00-0233 & 0335, September 18, 2001

Order, Commission Docket 00-0233 & 00-0335, September 29, 2009, Second
Interim Order on Rehearing, Commission Docket 00-0233 & 00-0335, March 13, 2002

Illinois Small Company Exchange Carrier Association website:

<http://www.isceca.org/index-2.html>.

Indiana

Indiana's Universal Service Fund (IUSF) has been operating since 2007. It replaced two prior funds: a Transitional Weighted DEM Fund and the Indiana High Cost Fund. Both of those funds had been available only to rural ILECs. The IUSF was created by the Indiana Utility Regulatory Commission (IURC) in response to rural ILECs' concerns regarding revenue shortfalls resulting from the MAG plan. Because Indiana mirrors interstate access charges, the MAG plan resulted in a decrease in both interstate and intrastate access charges. The Indiana Exchange Carriers Association, AT&T, SBC Indiana and Sprint, reached a Settlement Agreement in response to the rural ILEC's concerns. The IURC found the settlement agreement, with certain modifications, was in the public interest by creating the IUSF to provide a more transparent and explicit support method than had been the case with the prior two funds. The IURC also found that the fund would be competitively neutral and promote just, reasonable and affordable rates for telecommunications services.

The Commission order establishing the IUSF was passed in 2004 and the fund was to go into operation in 2005. However, unsuccessful appeals by some telecommunications carriers who contested the IURC's authority to create the fund and also claimed that the fund was not competitively neutral, delayed the establishment of the fund until 2007.

In establishing the IUSF, the IURC sought to deal with the revenue shortfalls caused by reductions in intrastate access charges without subsidizing lower rates for the customers of rural ILECs than the rates paid by customers of contributing carriers. Rural ILECs were required to raise their local service rates to prescribed benchmark levels in order to receive support from the IUSF and to pass a qualification test to show that they did indeed need support. The qualification test involved several steps:

Three years of a rural ILEC's intrastate net income was averaged.

The averaged income was adjusted to reflect benchmark rates of \$17.15 for residential service and \$23.60 for single line business service rather than the rural ILEC's actual local service rates. (A transition period was provided for rural ILECs who would have to increase their rates by \$6.00 or more in order to attain the benchmark rates.)

Federal support payments were subtracted from the adjusted averaged net income.

An 11.50% rate of return was applied to the rural ILEC's rate base (averaged over the three year period), resulting in a revenue requirement figure.

Adjusted averaged net income (less federal support payments) was compared to the calculated revenue requirement. If the net income was less than the calculated revenue requirement, the rural ILEC passed the qualifying test and was eligible to receive support from

the IUSF in an amount equal to the difference between averaged net income and revenue requirement. If the net income exceeded revenue requirement, the rural ILEC was ineligible for aid.

Support is recalculated every three years; recalculation will be done in 2010. Rural ILECs whose calculated revenue requirement exceeds their average adjusted net income will lose their eligibility for IUSF support. Qualifying rural ILECs receive support in monthly lump sum payments.

Although CETCs are technically eligible to apply for support from the IUSF, none has done so as yet. It is not clear how CETC support payments would be calculated, since the rural ILEC with whom they compete receive support in a monthly lump sum amount. The IURC requires service maps from supported carriers, including carriers who are federal ETCs.

As of July 1, 2009, VoIP providers in Indiana are required to be certificated. Large fixed VoIP providers, like the cable companies, have become certificated because they seek the benefits of being a telecommunication service provider (i.e., interconnection agreements, ability to get telephone numbers, etc.). Smaller fixed providers and nomadic providers have not all voluntarily become certificated. Although Indiana's 2006 deregulation law defines all providers as "communication service providers," there are still distinctions among subclasses of providers. For example, it is not yet clear whether VoIP providers are required to pay into the IUSF.

The IUSF is funded by a surcharge on retail bills and is administered by a third party, who levies penalties for late payments. Non-payment of the surcharge can result in a court case handled through the State Attorney General's office.

References

<http://www.in.gov/iurc>

State of Indiana, Indiana Utility Regulatory Commission, Cause No. 42144, March 17, 2004.

State of Indiana, Indiana Utility Regulatory Commission, Final Order, Cause No. 41052-ETC-47, June 8, 2005.

Kansas

The Kansas Universal Service Fund (KUSF) was first established in 1997 to provide two kinds of support: 1) a hold harmless provision to replace revenues lost by carriers as they reduced their intrastate access charges; and 2) annual support in the amount of \$36.88 for each qualifying access line. Initially, only ILECs received monies from the KUSF. In 2000, the fund changed to a cost-based approach under which rural carriers receive support based on their revenue requirements, and non-rural carriers receive support based on costs determined by a proxy model.

Support for rural carriers is based on intrastate revenue requirement. The revenue requirement is then adjusted for subscriber revenues, which are assumed to be no less than a floor level which is called "targeted affordable rates." As of March 2009, the targeted affordable rates for rural ILECs were \$15.75 for residential service and \$18.75 for single-line business service. When a company elects to maintain its rates below those targeted levels, KUSF support is reduced by the amount of revenue the carrier would have received by increasing actual rates to the targeted level. Revenue requirement is also adjusted for changes in intrastate access charges. Under a statutory mandate, every two years the commission adjusts the amounts of the targeted affordable rates and of allowable intrastate access rates.

For non-rural ILECs, KUSF support is also cost-based, but costs are derived from a cost proxy model. The Kansas Commission adopted the FCC's cost proxy model, with several adjustments to reflect Kansas specific inputs, such as taxes. The model produces costs at the wire center level, and the results are then disaggregated into two zones. One zone is a base rate area, generally the area within city limits. The second zone is outside the base rate area or city limits. KUSF support is provided to any zone with costs above 135% of the state average. Annually, this support is adjusted based on current line counts, but without recalculating costs.

Competitive ETCs (CETCs) receive support for lines they provide service to within the ILEC's service area, at the same per-line amount as is provided to the ILEC. As with ILECs, support for CETCs is adjusted annually to reflect changes to line counts.

In 2000, the commission adopted the practice of adjusting support to all carriers annually based on current line counts. After a court decision, this practice has now been modified for rural carriers. In 2005 a Kansas court held that the commission can increase or decrease a rural company's support only after conducting a revenue requirement analysis that evaluates the carrier's embedded investments and expenses.²⁵² As a result, rural ILEC support amounts now

²⁵² *Bluestem Tel. Co. v. Kansas Corp. Comm'n.*, 33 Kan. App. 2d 817 (Kan. Court of Appeals, 2005); review den, *Bluestem Tel. Co. v. Kan. Corp. Comm'n.*, 2005 Kan. LEXIS 597 (Kan., 2005).

remain fixed until recalculated by the Commission. CETC support, however, is still adjusted annually based on CETC line counts. The net effect is that an increase in competition can increase the amount of support paid out by the KUSF.

Funds for the KUSF are collected through a percentage surcharge on intrastate retail billed revenues. Carriers can recover the KUSF high cost surcharge through line items on customer bills. The Commission calculates a specific amount that ILECs can place on each customer's monthly bill. Specific dollar amounts are calculated for AT&T, for Embarq, and for all rural ILECs. CLECs, IXC's and other carriers can recover the surcharge as a percentage on their customers' bills.

All service providers, including satellite providers, wireless carriers, and VoIP providers are required to pay into the KUSF.²⁵³ However, the Vonage case in Nebraska has left the status of nomadic VoIP providers unclear. The KCC and the Nebraska PUC filed a Joint Petition at the FCC asking for a declaratory ruling. Time Warner and Cox are voluntarily contributing to the KUSF, as are a few other companies that have self-identified as VoIP providers. Vonage and other providers have challenged the KCC's authority for state USF assessments and are not contributing.

The Commission has been conducting revenue requirement audits of the rural ILECs. At this writing, 34 companies have been audited, resulting in a decrease in the KUSF of \$8.3 million. Three companies have not yet been audited.

References:

Kansas statutes K.S.A. 66-2002(h), K.S.A. 66-2008

Commission Dockets No. 94-GIMT-478-GIT, No. 06-GIMT-390-GIT, No. 08-GIMT-154-GIT.

²⁵³ Kansas statutes require that interconnected VoIP providers contribute, and the statutes do not make a distinction between fixed and nomadic providers.

Maine

The universal service fund in Maine, which was created by state statute, has been functional since 2002. A surcharge of 1.35% is assessed on intrastate services on customer retail bills, resulting in collections of about \$8 million annually. That percentage can be adjusted quarterly depending on the projected needs and revenue base. About \$7.4 million is used for the high cost fund; the remaining amount covers a public payphone program, a program to purchase equipment for the hearing impaired and a program to provide an alert system for the hearing impaired, and a telecommunications relay service program.

The Maine high cost fund is used exclusively as a credit against revenue requirement. The amount of support a carrier receives from the fund is determined by subtracting a carrier's intrastate revenues from its intrastate revenue requirement. A carrier's revenue requirement is calculated through a rate case using rate of return methods. Intrastate revenues are calculated by multiplying a carrier's billing units (access minute, residential lines, etc.) by the carrier's rates, except that for local service, benchmark rates are used. The benchmark rates for local service is the level of Verizon's local rates shortly before Verizon was sold to Fairpoint. The carrier's support from the high cost fund equals the amount that results when the carrier's intrastate revenues are subtracted from its revenue requirement. If the revenues exceed the revenue requirement, the carrier gets no support from the fund.

At this point, the only ETCs supported by the Maine fund are 12 rural ILECs. No CLEC has applied for state funding because, in order to receive money from the Maine high cost fund, a carrier has to undergo a rate-of-return rate case with the Maine Public Utilities Commission to determine support. No CLEC has wanted to do this as yet.

The Maine Public Utilities Commission (MPUC) established the universal service fund high cost fund at the same time it was reducing state access charges and expanding Basic Calling Service Areas (EAS areas). The Maine PUC did mini-rate cases for all the ILECs, except for Verizon, using the lower intrastate access charges, the revenues from expanded Basic Calling Service Areas and benchmark local rates. Intrastate access charges were lowered to mirror interstate rates at that time; access charges have not been lowered further, and the current intrastate access charges mirror NECA's interstate rates from several years ago, rather than current interstate access charges.

ILECs currently receive the amount of support that was calculated several years ago; neither the ILECs nor the Maine PUC have initiated action to recalculate the support amounts. Theoretically, the ILECs could benefit from a recalculation of support because the benchmark rates that were used in the calculation are \$4.00 higher than the local service rates Fairpoint currently charges in the service areas it purchased from Verizon. When the Fairpoint purchase was under negotiation, the Maine PUC found through a rate case that Verizon had been over-earning. Fairpoint agreed to lower local rates by about \$4.00 as a result. While it is possible that

lower benchmark rates could result in higher support payments from the fund, it is also possible that a recalculation could result in lower revenue requirements for the ILECs receiving support.

While no CLEC has come forward to apply for state ETC status, that has not been the case for federal ETC designations. One wireline and two wireless carriers have received federal ETC designation; the wireline carrier and one of the wireless carriers have since asked to have that designation rescinded.

VoIP providers are not certificated in Maine; however, one division of Time Warner Communications, though not the division that provides retail services, did ask for and receive certification. Time Warner, though now asking to be de-certificated, is contributing to the fund.

The fund is managed by a third-party, and the Maine PUC requires annual reports from state ETCs and ILECs whether or not they receive Maine support, and also from ETCs with federal designations.

References:

Maine Rev. Stat. Title 35-A, §7104

Commission Rules, 65-407, Chapter 288

Nebraska

Nebraska's high cost fund has been functioning for a decade. The Nebraska Public Service Commission (NPSC) is the custodian and administrator of the Nebraska Universal Service Fund (NUSF). Funds are collected through a surcharge (currently 6.95%) levied on intrastate retail revenues. The amount generated by the surcharge covers the high cost fund, a separate fund that provides grants to wireless providers to build facilities in un-served and underserved areas, a telehealth fund to provide support to the Nebraska Statewide Telehealth Network, and the state Lifeline fund. The surcharge is collected through a line item amount on retail customers' bills.

The NUSF was established by statute in 1997. It began as a transitional revenue replacement fund, and then in 2004, the Commission moved to a cost-based approach. Originally, carriers were asked to reduce their state CCLC to zero, restructure other in-state access rates, and transition local rates to rate benchmarks determined by the Commission. The remainder of the amounts necessary to achieve revenue neutrality was then recovered through funds distributed from the NUSF. If after all of these actions, a carrier's earnings exceeded a 12% rate-of-return, a corresponding amount of NUSF funding was forfeited.

Since 2004, support from the NUSF has been an allocation based on a comparison of total cost and total revenue generated per line. The Benchmark Cost Proxy Model was used to relate household density to average loop cost, the results of which were used to link measured density in each support area to expected loop cost and determine relative allocations.

To determine cost, the NPSC used the Benchmark Cost Proxy Model to model cost at the sub-wire center level and relate the resulting cost to household density using regression analysis; the result is a computed cost per line. Revenue is calculated beginning with a local benchmark rate for residential service, currently \$17.95. Once converted to total cost, other revenue amounts are added to the benchmark rate, specifically a carrier specific SLC, an imputed DSL revenue amount (the same for all carriers), an average per line amount by which a carrier's intrastate access rates exceed the state's minimum intrastate access rates, and finally converted to revenue per household. The resulting total revenue per household is compared to the total cost per household computed for that specific area. A support area is allocated support when the total cost per household is greater than the total revenue per household. Subsequent adjustments to allocated support are made: earnings exceeding a 12% rate-of-return; federal universal service support received; and a rural benchmark imputation, currently \$19.95.

Incumbent Local Exchange Carriers (ILECs), Competitive Local Exchange Carriers (CLECs), Interexchange Carriers (IXCs), wireless providers, and fixed Voice Over Internet Protocol (VoIP) providers all contribute to the NUSF. Vonage is contesting the NPSC's ability to assess the NUSF surcharge on nomadic VoIP service providers. Fixed VoIP are not required to be certificated, but they can voluntarily ask for certification. Both fixed VoIP and wireless providers can use the FCC's safe harbor percentages to determine the intrastate revenue base on which to assess the 6.95% surcharge. The NUSF declined by 17.8% in 2007 because the FCC

increased the federal portion of the safe harbor percentages. Because not all carriers are certificated, the NPSC has to use several venues to identify carriers who are subject to the surcharge. All broadband, VoIP, and wireless providers are required to register in the NPSC's communication provider registry. All carriers are required to update a contact database annually. In addition to the database and the registry, the NPSC also refers to the Secretary of State's website, newspaper ads and the yellow pages to identify carriers.

Theoretically any carrier is eligible to receive aid from the high cost fund. However, the Commission provides high cost support to one facilities-based network in a given support area. At this point, only the networks of current ILEC carriers have been designated as state ETCs (NETCs) for the purpose of receiving high cost support. Another carrier may petition the Commission to be designated as the eligible network provider within a given support area. Such carrier must; accept Carrier-of-Last-Resort (COLR) responsibilities; and comply with all interconnections requirements of the Telecommunications Act of 1996, all reporting requirements, and all existing ILEC Interconnection Agreements.

Carriers need only be certified as NETCs to receive NUSF funds; designation as a federal ETC is not required. The NPSC uses the FCC's recommended requirements to determine federal ETC designation: five-year network improvement plan, ability to remain functional in an emergency, ability to satisfy consumer protection and service quality rules, provision of a local usage plan, and ability to provide equal access. The NPSC uses the FCC's list of supported services and has no plans to expand that list.

In 2007, for areas served by Qwest, the NPSC adopted a form of identical support for CLECs, the NUSF porting methodology. Under the porting methodology, a CLEC receives support amounts equal to the minimum of the per line amount received by the ILEC or the difference in the UNE loop rate and the respective benchmark. However, Qwest has challenged an NPSC order which further deaveraged the UNE zones. The NPSC further disaggregated geographically cost-based UNE zones creating an in-town rate and an out-of-town rate for each of the three zones.

In addition, the NPSC implemented several accountability measures to ensure that NUSF funds are being used appropriately. Carriers receiving NUSF funds are audited annually by an independent third party auditor. Also, ETCs and NETCs are required to file annual reports that include information about network improvements (one historical year and one forecasted year), outages, unfilled requests for service, and customer complaints. Further, in 2008, for carriers receiving NUSF support, the NPSC adopted an expense cap model mechanism for review of expenses. This mechanism is an important objective tool for proper oversight of the appropriate use of NUSF support and further promotes public accountability to ratepayers.

References:

Neb. Rev. Stat. §86-316--§86-329

Commission Orders, NUSF-26 and NUSF-50

Nevada

The Nevada Universal Service Fund (NUSF) covers multiple programs, including high-cost support, supplemental aid to schools and libraries, supplemental aid to rural health care providers and the extension of basic service to previously un-served/underserved areas. The NUSF expects to expend approximately \$226,000 in 2010.

Nevada established a high-cost fund in 1995 known as the Fund to Maintain the Availability of Telephone Service (FUMATS). The fund is reserved only for providers of last resort (POLRs). At this time, only ILECs are designated as POLRs. In general, the FUMATS is targeted at small rural ILECs. A large ILEC or a competitive POLR may petition for high-cost support, but it would bear the burden of demonstrating that circumstances warranted for it to receive support to keep basic service rates at affordable levels. To date, no large ILEC or competitive provider has petitioned for support.

The high-cost support level is determined through reference to an applicant's intrastate revenue requirement using the authorized intrastate rate of return. To be eligible for support, the applicant's intrastate revenue requirement must exceed the sum of its intrastate revenues and federal universal service support. The carrier must also meet two additional conditions: (1) the company's interstate and intrastate switched access rates must be in parity, or the company must agree to carry out a plan to achieve the parity specified by the Commission; and (2) the company's local rates must fall between \$8-16 per month for residential lines and \$16-20 per month for business lines. An ILEC may petition to raise the rate above the upper threshold.

Requests for high-cost support must be submitted annually. An applicant for support must submit a request to the fund administrator 180 days before the beginning of the calendar year for which money is requested. The fund administrator conducts the preliminary review of the company's earnings, determines the appropriate amount of support and reports to the Commission for final approval. To date, only one rural ILEC has requested and has been receiving support from the fund. Because that carrier did not request support for 2008 and 2009, there were no high-cost fund disbursements, and collections for the high-cost fund were suspended. The carrier has requested aid for 2010; the Commission has determined that the existing fund balance is sufficient to provide the carrier with the requested support and also to cover the administrative costs of the fund's third party administrator.

The NUSF is funded by a percentage surcharge on intrastate retail receipts. The rate is currently zero because the state is spending down an existing fund balance; the last surcharge levied was 0.0025 percent. Both wireline and wireless providers contribute to the fund. Certificated VoIP providers also pay the assessment. Carriers can pass NUSF surcharges through as a line item on consumer bills. Solix is the current administrator, selected by the Commission through a competitive bidding process.

In participating in the federal Lifeline program, ILECs in Nevada provide additional support to obtain the federal Tier Three matching support. However, no ILECs have requested any reimbursement from the state USF. There is a rule change proposal to streamline requests for reimbursement.

There are 13 rural ILECs in Nevada, all of which are under rate-of-return regulation. The two non-rural ILECs, Embarq and AT&T, are classified as competitive suppliers and are subject to a deregulation plan under which their basic rates have been frozen until 2011. As is the case with commissions in many other states, if the FCC mandates future reductions in intrastate access rates, the Commission will face the possibility of expanding the state fund to offset rural ILECs' revenue losses.

References:

Nevada Utility Law. NRS 704.6873. Available at

<http://www.leg.state.nv.us/NRS/NRS-704.html#NRS704Sec6873>

Nevada Administrative Code NAC 704.68046, 68048 and 68056.

Available at <http://www.leg.state.nv.us/NAC/NAC-704.html>

Docket 09-09025. Solix, Inc. Filing (Oct 1, 2009)

Proposed Regulation of the Public Utilities Commission of Nevada.

File No. R087-09. Available at

<http://www.leg.state.nv.us/register/2009Register/R087-09P.pdf>

<http://www.solixinc.com/internet/source/currentprograms.aspx?id=484&ekmense1=c580fa7b28244btnlink>

New Mexico

The New Mexico Rural Universal Service Fund (NMRUSF) was created in response to state statute requiring reductions in intrastate access charges, rebalancing rates and compensate eligible carriers primarily ILECs in a revenue-neutral manner for reducing their intrastate access rates to interstate levels while at the same time rebalancing their local rates. The fund began operation on April 1, 2006. There had been efforts to create a fund prior to the NMRUSF, but it was not possible to reach consensus about the fund. During these prior efforts, \$2 million had been collected, but no monies had been distributed and the \$2 million was rolled into the NMRUSF.

The NMRUSF is supported by a state USF surcharge rate paid by all entities that provide intrastate retail public telecommunication services and comparable retail alternative services in New Mexico, including local and intrastate toll service providers, access providers, CMRS providers, operator service providers and pay phone providers. Interconnected VoIP carriers and wireless carriers may use the inverse of the federal safe harbor for estimating intrastate revenues. The fund administrator and the commission staff keep track of VoIP providers through the certification process as well as by referring to service advertisements, the FCC 499 database and reports by the VoIP providers to the administrator. The commission has been in court with a VoIP provider who is not contributing to the fund. The fund is deemed by statute "not public funds" and is collected and support disbursed to carriers by a contract administrator, currently Solix Inc.

Support from the fund is determined by first calculating revenues lost from lowering intrastate access charges during a base year, and then adjusting for the revenues gained from increasing local rates to a benchmark level. The detailed formula is as follows:

$$\text{Support} = \text{Access Revenue Loss} - \text{Local Revenue Increase}$$

$$= ((\text{Historical Access Rate} - \text{Allowable Access Rate}) \times 2004 \text{ access minutes} \times \text{Historical Collection Factor} - \text{Imputed Benchmark Revenue})$$

The *Historical Access Rate* means the per-minute intrastate access charge in effect for a carrier as of July 1, 2005. The *Allowable Access Rate* is the specified cap for intrastate access rates during the three-year phase-in period²⁵⁴ and after January 1, 2008; they are identical to the carriers' interstate access rates. The *Historical Collection Factor* means the ratio, for calendar year 2004, of intrastate switched access charge revenue collected by a carrier to its gross charges for intrastate switched access, not to exceed 1. The *Imputed Benchmark Revenue* is the revenue gained from raising local rates to "affordability benchmark rates," which are set at the level of Qwest's local rates plus its intrastate SLC. For residential service that benchmark was set at a residential rate of (based on $13.50 + 1.78$ benchmark = \$15.28 and \$15.18 ($\$13.50 + \1.68); for business service at rate benchmark-up of up to 36.15.

A carrier must be designated as an ETC to receive support from the fund. Theoretically, any carrier could petition for ETC designation for state support, including a CLEC. However, only rural ILECs have been approved to receive support from the state fund. Qwest is the only non-rural ILEC in New Mexico; rather than recovering lost access revenues from the fund, Qwest was allowed to charge a state SLC of \$1.68 (the original 1.78 reduced to \$1.68 reflecting refunds to rate payers) to its customers. Qwest's local rates are used as affordability benchmark rates, as described above. Because of the historical nature of the support calculation, CLECs have found it difficult to determine how to calculate support from the fund. Several CLECs elected to file a state SLC and none are receiving support from the NMRUSF.

The revenue surcharge for the fund is reviewed annually, and the most recent rate was set at 2.450%, effective January 1, 2010. The rate is assessed on intrastate retail revenues. The projected fund size was set at \$24,237,580.

In fiscal year 2007-2008, the program collected \$23,164,951. The total expenditures were \$24,012,534 in calendar year 2007. Carriers may recover their contributions through a line item on their customers' bills. Native Americans residing on or near their tribal lands are generally exempt from the surcharges.

The state commission selected a third-party administrator to operate the fund through a bidding process. The current administrator is Solix, Inc. All Solix's documents and rules are subject to commission review. Based on NM Administrative Code 17.11.10.12, the fund

²⁵⁴ The *Allowable Access Rate* during the transitional years are as follows:

- Effective April 1, 2006, not to exceed the carrier's historical access rate, less 1/3 of the difference between its historical access rate and its January 1, 2006 interstate access rate.
- Effective January 1, 2007, not to exceed the carrier's historical access rate, less 2/3 of the difference between its historical access rate and its January 1, 2006 interstate access rate.
- Effective January 1, 2008, not to exceed the carrier's January 1, 2006 interstate access rate; and its intrastate access elements and structure shall conform to those of its interstate access tariff.

administrator must conduct reviews, not less than once every year, to ensure that each contributing company is making its required contributions to the fund and that support from the fund is used for the specified purpose. Solix reviews a selected sample of carriers including contributors and fund recipients.

In 2008, Solix reported to the legislature regarding the fund and its operation and did not recommend any changes in the current state high cost fund assessment rate. There is a rule making including a proposal supported by most ILECs to establish an additional state fund to pay for the state match for federal Lifeline and Link Up subsidies. Currently, some ILECs provide monies to augment the federal Lifeline payments to get additional federal matching funds.

Reference:

New Mexico Administrative Code 17.11.

Oklahoma

Oklahoma has two funds: the Oklahoma Universal Service Fund and the Oklahoma High Cost Fund. The Oklahoma Universal Service Fund (OUSF) serves three basic needs: 1) "Primary Universal Service" provides rural consumers with access to telephone services that are affordable and reasonably comparable to urban telephone services. 2) "Special Universal Service" provides funding for a) internet connections to public schools, libraries, and county seats; b) toll free 1-800 lines for public schools; and c) telemedicine. 3) "Lifeline" support provides economically disadvantaged consumers with low cost telephone service. The lifeline support is sometimes referred to as the Oklahoma Lifeline Fund (OLF). The OLF is not a separate fund but is a component of the OUSF.

The OUSF was created by state statute, 17 O.S. §139.101 et seq. The OUSF is funded by contributions from telecommunications providers as a percentage of the total retail-billed Oklahoma intrastate telecommunications revenues for both regulated and unregulated services. Contributions to the OUSF may be passed through to consumers. Local exchange carriers, long distance carriers, wireless carriers, operator service providers and payphone service providers contribute to the OUSF. VoIP providers do not contribute to OUSF. The Commission establishes a budget and adjusts the OUSF rate annually. The Commission also conducts regular audits of telephone companies that receive money from the OUSF.

Primary Universal Service supports rural carriers. A rural carrier is defined as an incumbent local exchange carrier (ILEC) serving fewer than 75,000 access lines. One notable component of Primary Universal Service in Oklahoma is the "make-whole" provision of Oklahoma law. The "make-whole" provision allows rural carriers to recover revenue lost as a result of any federal or state change in law, regulation or order. Funding requirements for Primary Universal Service programs have experienced modest growth over the last five years.

Special Universal Service schools and libraries programs supplement E-Rate funding. Accordingly, the state and federal programs work in concert to provide Internet access to schools and libraries. Special Universal Service also funds telemedicine and a toll-free telephone number to schools. In many instances, telemedicine and toll-free telephone numbers for public schools are paid exclusively through the OUSF. Also, OUSF pays for telemedicine projects to a broader array of healthcare facilities than those covered by the federal fund for rural health care facilities. While the Commission encourages carriers to seek federal funding sources for telemedicine, federal funding sources are not always available for telemedicine projects that are eligible for OUSF support. The OUSF supports both the initial build-out and the ongoing maintenance of all Special Universal Service programs with the exception of ISP connection costs. Funding requirements for Special Universal Service have experienced significant growth over the last five years, particularly in the area of telemedicine.

The OLF Lifeline programs supplement federal Lifeline programs. Accordingly, the state and federal programs work in concert to provide Lifeline services. Funding requirements for Lifeline programs have experienced modest growth over the last five years.

The Oklahoma High Cost Fund (OHCF) provides support to rural incumbent local exchange carriers (RLECs). The OHCF is a state fund that is separate and distinct from the OUSF. The OHCF was created by Commission order in 1996 and has not been modified or changed since that time. The OHCF is supported by contributions from intrastate toll providers (IXCs). Contributions to the OHCF may be passed through to consumers.

The OHCF replaced the intrastate toll pool in place prior to 1997. The OHCF distributes a fixed amount to rural carriers each year as stipulated in the 1996 settlement. The fixed amount is based on the amount each carrier received from the toll pool in 1994 with very limited opportunities for adjustment. The total size of the OHCF is fixed at approximately \$37 million annually. An IXC's contribution to the OHCF is calculated annually based on the IXC's proportional share of the total intrastate retail billed minutes of use.

The Oklahoma Corporation Commission is considering several reform proposals on the OUSF and OHCF, such as, changing the contribution methodology and distribution standards for the OUSF and/or eliminating or reforming the OHCF. However, no changes have been made at this time.

References:

- <http://solixinc.com/internet/source/currentprograms.aspx?id=492>
- Oklahoma Telecommunications Act of 1997 (17 O.S. §§139.101 – 139.110)

Oregon

The Oregon Universal Service Fund (OUSF) was created by the Oregon Public Utility Commission under legislative mandate. The legislature's impetus for mandating the creation of the fund was to stabilize rates as competition developed. The fund has been functioning since 2000 and in fiscal year 2009 collected \$49 million.

ILECs, CLECs, and IXC's all contribute to the fund. Wireless providers do not currently contribute to the OUSF and VoIP providers are not required to contribute. However, the state's largest VoIP provider (a cable company) has voluntarily asked for certification and is a fund contributor. Contributions to the fund are based on a surcharge that is applied to intrastate retail revenues. The current surcharge is 7.12%.

While the Oregon Commission has custody of the fund, a third party serves as fund administrator. Service providers submit their contributions to the Commission, which deposits the funds; at the same time a record of the payment is made to the third party administrator who maintains a database of fund transactions and also deals with delinquent payments. The third party administrator is audited each year by an independent auditor. The Commission is developing a web based system through which carriers will be able to input required data and also submit their payments to the fund.

The OUSF makes a distinction between rural and non-rural ILECs in calculating fund support. Support amounts from the OUSF vary from a low of \$0.22 to \$685.20 per line. For the large non-rural ILECs, a cost proxy model is used to determine cost per loop at the wire center level. The resulting per-line cost for each wire center is reduced by a \$21 benchmark rate. The resulting difference, if any, constitutes the support from the OUSF. The cost proxy model has not been updated since the inception of the fund, and so support amounts for the larger carriers have been set since then.

Embedded costs are used to calculate support for the small rural ILECs. This support is calculated every three years and it equals the carrier's costs reduced by federal support and the \$21 benchmark rate. The carrier's revenue requirement for loop and local traffic sensitive facilities is converted to a per-line amount by dividing the total revenue requirement by the carrier's number of lines; the resulting amount is then divided by 12 to arrive at a monthly per-line figure. The per-line amount is the same for all the carrier's wire centers, unlike the procedure for the larger ILECs. This amount (which is essentially revenue requirement per line) is then reduced by federal support. Specifically, 25% of the loop cost, or the sum of the calculated Subscriber Line Charge plus any interstate loop support (whichever is greater) is subtracted from the revenue requirement per line. Any federal local switching support is also subtracted. The resulting amount is further reduced by the \$21 benchmark. Any remaining amount constitutes the support from the OUSF.

When the triennial calculation of support was done in 2006, the Commission, in an effort to restrict the growth of the OUSF, froze support at 2003 levels plus 15%, resulting in the 7.12% surcharge. In its 2009 study, the Commission made no increases, leaving the 7.12% surcharge in place.

CLECs are eligible for support from the OUSF. They must be certificated, receive ETC status, and also pay into the OUSF for over a year. So far only one CLEC is receiving support from the OUSF. Support for Competitive ETCs (CETCs) is based on the support received by the ILEC for that wire center. If the CETC is providing service using its own facilities, it gets the same support as the ILEC. If the CETC is providing support through UNEs, it gets partial support. If the CETC is providing support through resale, it gets no OUSF support.

References:

ORS 759.015

Order Number 98-094

Pennsylvania

The Pennsylvania Public Utility Commission created the \$34 million PA-USF in 2000 in response to petitions from both local exchange carriers and IXC's. The purpose of the PA-USF, as articulated in the Commission's Final Rulemaking Order, is to "reduce access and toll rates for the ultimate benefit of end-users and to encourage greater toll competition while enabling carriers to continue to preserve the affordability of local service rates."²⁵⁵

The PA-USF is a revenue replacement fund, with support limited to rural ILECs. At the initiation of the fund, intraLATA toll rates were reduced, the intrastate Carrier Common Line Charge was replaced with a flat rate Carrier Charge, and other intrastate access charges were reduced closer to interstate access charge levels. At the same time, ILECs were allowed to increase local residential rates up to a cap of \$16.00 per month. Support payments from the PA-USF were calculated by netting additional revenues from increased local rates against decreased revenues resulting from reductions in access charges and toll rates; if the additional revenues were not sufficient to make up for the decreases in revenues, the PA-USF made up the shortfall. The \$16.00 cap was later increased to \$18.00 in 2003 when intraLATA toll rates were further decreased and support amounts from the PA-USF were recalculated accordingly.

The size of the fund and the annual assessment rate is recalculated each year and approved by the Commission. The fund is increased to reflect access line growth for rural ILECs but is not reduced in the event of a decline in lines. All LECs and IXC's contribute on a pro rata basis to the PA-USF. Contributions are calculated by applying an assessment rate (1.1094904% in 2009) to intrastate end-user retail telecommunications revenue. The formula used for calculating contributions is as follows:

$$\frac{W + X + Y + Z}{A} \times \frac{B}{12} = C$$

W = Increase in funding requirement due to growth in access lines of recipient carriers. W equals access line growth percentage for each recipient carrier multiplied by each recipient carrier's prior year net support (prior year funding minus prior year payment).

X = Prior year's size of fund minus estimated any surplus from prior year or plus any shortfall from the prior year.

Y = Provision for uncollectable—set at 1%. {1% x (X+W)}

Z = Commission approved administrative and auditing expenses

²⁵⁵ Rulemaking Re Establishing Universal Service Fund Regulations at 52 Pa. Code §§63.161-63.172, Final Rulemaking Order, Docket No. L-00000148, (November 29, 2000).

A= Aggregate state-wide end-user intrastate retail revenue of all contributing telecommunications providers for the previous calendar year

B= Individual contributing telecommunication provider's end-user, intrastate retail revenues for the previous calendar year

C= individual contributing telecommunication provider's monthly contribution

The fund is administered by a third party. Contributors to the PA-USF are prohibited from recovering their contributions through line item surcharges on customer bills. Verizon Pennsylvania Inc. (Verizon PA) uses its 2003 Price Change Opportunity monies to fund its annual contribution to the PA-USF. (Verizon PA is under price cap regulation in Pennsylvania, but although it is an ILEC, it is not a rural ILEC recipient of the PA-USF). Most of the other ILECs are net receivers from the PA-USF rather than contributors. (As noted in the formula above, the rural ILECs' contributions are netted against their support payments when the fund size and assessment percentage are calculated.)

Currently, all certificated telephone carriers contribute to the PA-USF. CMRS providers do not contribute. Certificated VoIP providers would be required to contribute; however, no VoIP providers are currently certificated. The contribution base for the PA-USF has been declining by about 3% each year; this has encouraged the Commission to consider adding CMRS and VoIP providers as contributors to the fund.

The fund was originally envisioned as an interim measure to last four years; however, there is no sunset provision in the regulations at 52 Pa. Code §§ 63.161 – 63.171. An investigation is currently underway before the Office of Administrative Law Judges to consider various issues related to the fund, including questions about the size of the fund and whether to expand its purpose to include keeping rates affordable in rural ILEC territories during periods of revenue increases. As part of this investigation, needs test analyses are being conducted.

Pennsylvania is actively promoting broadband deployment by its telecommunications carriers. As part of alternative regulation proceedings, carriers made commitments for delivery of broadband in return for decreased regulatory oversight.

References:

Global Order, Re Nextlink Pennsylvania, Inc., Docket Nos, P-00991648, P-00991649, Order entered September 30, 1999, 196 PUR4th 172

Final Rulemaking Order at Docket No, L-00000148 on January 27, 2000.

52 PA. Code CH. 63

South Carolina

(The following discussion is based on an interview with Commission staff members; but it has not undergone a final staff review.)

South Carolina funds its universal service efforts through two funds. An Interim Local Exchange Carrier Fund (ILF) to which only interexchange carriers (IXCs) contribute, and a Universal Service Fund (SC USF). The establishment of state universal service mechanisms in South Carolina was in response to the federal Telecommunications Act of 1996 and the push from a state telecommunications industry coalition seeking to keep incumbent local exchange carriers (ILECs), especially rural local exchange carriers (LECs), competitive in the market. The rationale underlying the state funds is that rural LECs cannot be competitive so long as their local rates continue to be subsidized by access charges and other vertical features. The state high cost mechanisms are intended to keep incumbent LECs whole on a revenue neutral basis when they reduce the non-basic rates that previously provided implicit subsidies to local rates.

The ILF was established as part of intrastate access charge reform, a reform asked for by the state's IXCs who sought lower access charges. All rural LECs were required to reduce their intrastate access charges to the level of those of the largest ILEC in the state, BellSouth, now AT&T. IXCs, including BellSouth, pay into the ILF and in return benefit from rural LECs' lower intrastate access charges. The ILF replaces the revenue lost from access charge reductions, with the incumbent LECs receiving payments based on their number of intrastate access minutes in 1996. Adjustments are made for growth in minutes, but no adjustments are made for a decrease in minutes. The ILF is about \$40 million per year. Though there are plans to incorporate the ILF in the SC USF, this has not yet been done and the ILF continues as an independent fund.

The South Carolina Universal Service Fund (SC USF) was implemented in 2001 and started functioning in 2002. It includes High Cost Support, a Lifeline program and Telecommunications Relay Service. In Fiscal Year 2007-2008, the state fund collected about \$54.6 million.

All wireline carriers that offer intrastate telecommunications services, including incumbent and competitive LECs and IXCs, are required to contribute to the SC USF. The SC USF surcharge is not assessed on wireless carriers unless they are designed as Eligible Telecommunications Carriers for receiving federal USF, which indicates that they compete with ILECs. VoIP providers are required to contribute to the fund only if they seek state certification as a competitive LEC (e.g., Time Warner Cable and Comcast). Nomadic VoIP providers do not contribute to the fund.

The South Carolina Office of Regulatory Staff administers the High Cost Fund and periodically audits the books of the fund recipient. The State Treasurer has custody of the fund.

The SC USF is collected through a percentage revenue surcharge on contributing carriers' retail receipts. The current rate is 3.5707%. The SC USF is unique in using both interstate and intrastate receipts. The South Carolina Supreme Court affirmed that the state has the right to assess state USF on interstate revenue based on the rationale that the federal USF recovers only a fraction of the carriers' costs of providing intrastate services.

Only carriers of last resort, now only incumbent LECs, are eligible to withdraw from the High Cost Support. So far, no competitive LECs have applied for the fund; to qualify they would have to assume carrier of last resort duties. Support from the SC USF begins with a calculation of a carrier's revenue requirement, with embedded costs used for rural LECs, and proxy model costs used for the non-rural LEC, BellSouth. These revenue requirements serve as a cap on total support available from the SC USF, and are not changed unless a carrier comes in to request a change in the calculation. Once a revenue requirement is calculated, a total cost per line is determined. State High Cost support per line is equal to the total revenue requirement minus approved tariff revenue and other sources of subsidy such as federal high cost support and ILF. ILECs are compensated dollar for dollar for any revenue loss resulting from a rate reduction for non-basic services such as access charges and vertical services. Carriers cannot reduce rates for these services below economic cost. If an ILEC loses access lines, the state USF support per line will be adjusted upward to meet its revenue requirement. All ILECs file financial worksheets annually to true up their USF receipt.

When the SC USF was established, the legislature provided for a maximum of \$217 million in annual support, to include both the ILF and the USF. The maximum has never been reached. The \$217 million was to be attained in three phases. In the first phase, all carriers including BellSouth were required to reduce their intrastate access charges and to file the required cost studies to establish the SC USF. To trigger the second phase, carriers would be required to file new cost studies and to demonstrate that additional funding is needed. That has not happened and, as of now, no carriers have passed the first phase.

Currently, all rural LECs are under alternative rate regulation. Carriers are allowed to raise their local rates up to the state weighted average rate, currently \$14.35.

There are a couple of new challenges facing the state High Cost Support. There is a debate about whether the fund should support service bundles, which are currently not regulated. There is also a question regarding the interaction between deregulation and state USF. There is pending legislation in the state General Assembly that will require those ILECs who elect deregulation to phase out their state High Cost Support.

References:

The Public Service Commission of South Carolina. 1996. *Order In Re: The Interim Local Exchange Carrier Fund*. Docket No. 96-318-C – Order No. 96-882-C. Released December 30, 1996.

The Public Service Commission of South Carolina. 2001. Order Approving Final Documents and Vacating Order No. 2001-954 In Re: Proceeding to Establish Guidelines for an Intrastate Universal Service Fund. Docket No. 97-239-C – Order No. 2001-996. Released October 10, 2001.

South Carolina Legislative Audit Council. 2005. *A Review of the South Carolina Universal Service Fund (Summary)*. Available at http://www.lac.sc.gov/NR/rdonlyres/ADDEC770-E5DB-4F4C-AFDD-118F6AE8B845/0/USF_Summary.pdf.

Texas

The Texas Universal Services Fund (TUSF) was originally authorized by the Texas Public Utilities Regulatory Act in 1987. The TUSF was revised and expanded multiple times during the late 1990s and early 2000s. The total annual fund disbursement in recent years has been between \$500 and \$600 million, making the TUSF the second largest state USF in the nation. The TUSF includes eleven programs, of which six provide high cost assistance:

Programs for high cost assistance:

Texas High Cost Universal Service Plan (THCUSP) for large companies and eligible competitors serving their areas;

Small and Rural ILEC Universal Service Plan for small, rural companies and eligible competitors serving their areas;

Public Utilities Regulatory Act §56.025 Maintenance of Rates and Expansion of Fund for Certain Companies;

Uncertificated Areas;

Successor Utilities;

Additional Financial Assistance (AFA)

Programs for low-income or disability assistance:

Lifeline and Link Up for low-income households;

Telecommunications Relay Service (Relay Texas);

Specialized Telecommunications Assistance Program (STAP) for the deaf and the hearing impaired;

Audio Newspaper Assistance Program (ANP) for the blind and visually impaired persons: provide access to the text of newspapers with synthetic speech technology;

Programs for schools, libraries and health care facilities:

IntraLATA: ILECs that have not elected incentive regulation may request reimbursement for certain intraLATA, interexchange, high capacity (1.544 Mbps) private network services at reduced rates for qualified schools, libraries, non-profit telemedicine centers, public or non-profit hospitals, or legal consortium of such entities.

TUSF is supported by a surcharge (currently 3.4%) on intrastate telecommunications revenue receipts. Receipts from payphone services, interstate and international services and the TUSF surcharge revenue itself are exempt from the assessment. Telecommunications providers may recover the assessment through an explicit surcharge on customers' bills; Lifeline customers are exempt from the surcharge.

All telecommunications service providers who have a customer base and intrastate revenue pay into the TUSF. Contributors include LECs and IXC's, and also wireless providers. VoIP providers are not contributors. Unlike other states, the TUSF collects contributions from other types of companies offering telephone services. There are approximately 700 other companies such as hotels and motels that contribute to the fund. The commission is considering a rule change to exempt these contributors. Texas allows wireless providers to use the inverse to the FCC's interstate safe harbor percentage to calculate their intrastate revenue. The Texas Commission has no imminent concern about sustainability of the fund because population growth has held the revenue base stable in recent years.

To be eligible for state support, a carrier must be designated by the commission as an Eligible Telecommunications Provider (ETP). Under the competitive neutrality principle, a competitive provider at least partially using its own facilities can seek the ETP status. An ETP must first be designated as an ETC for receiving federal USF. ETP designation entails more stringent conditions beyond the ETC qualification. For example, a carrier must offer flat rate unlimited local calling services; the local service rate must be no higher than 150% of the ILECs' state average rate; the carrier must also comply with state quality of service rules.²⁵⁶

To qualify for state high cost support, an ETP must also provide basic local telecommunications service (BLTS).²⁵⁷ Texas commission reviews the definition of BLTS every three years. The following summarizes the six high-cost programs in Texas:

Texas High Cost Universal service Plan" (THCUSP)

THCUSP is the state high-cost fund for Texas's large carriers or eligible competitors serving the same areas. It is the biggest of the TUSF programs, expending over \$400 million annually (75-76% of the total fund). ILECs receive over 95% of THCUSP support. The program started around 1998-1999 as a result of restructuring of an older "Texas Universal Service Fund."

THCUSP per-line support level is determined by the following formula, at the wire center level:

Support = economic cost – revenue benchmark – federal USF – access/UNE adjustments

²⁵⁶ Texas Admin. Code § 26.52 - 26.54.

²⁵⁷ Texas Admin. Code § 26.403(d)(1).

The commission uses a forward-looking economic cost model (Hatfield Model) to calculate monthly per-line cost of each wire center. The commission sets a uniform revenue benchmark across wire centers based on the statewide average per-line revenue. The benchmark is \$38 for residential lines and \$52 for business lines.

The access adjustment applies only to some carriers. Each of the ILECs receiving support from the THCUSP has elected incentive regulation. These ILECs agreed to reduce their switched access charges and intraLATA toll rates. If an ILEC has not in fact reduced its access rates, the access reduction further reduces its base support. That reduction amount is equal to the sum of the ILEC's carrier common line revenue, residual interconnection charge revenue and residual toll revenue. The calculated per-line support is portable to competitive ETPs.

The UNE adjustment also applies only to some carriers. If an ETP provides supported services solely or partially through the purchase of unbundled network elements (UNEs), its support is allocated between the ETP and its UNE provider.

THCUSP recipients must report line counts, rates and support calculation to the TUSF administrator on a monthly basis; report THCUSP receipts on a quarterly basis; and report its qualification for THCUSP on an annual basis.

The Texas commission has recently modified the THCUSP. Over a four year transition, it allowed large ILECs to raise local rates in regulated areas. This plan will raise the lowest local rate from \$7 per month to \$17 over the four years. Such change increased the revenue benchmark and therefore reduced the need for TUSF support. As a result, the assessment rate declined from 4.4% to 3.4%. The commission may also consider updating the cost model as the costs currently being used are based on 1997 data.

Small and Rural ILEC Universal Service Plan

This is the second-largest program of the TUSF. It disburses about \$100 million per year (17% of TUSF) to 20-30 rural telephone companies and competitive providers serving the same areas. The ILECs and CLECs receive about 98% and 2% of the fund, respectively. This program was initiated in 1998 and implemented in 2000. It replaces support previously generated by an intraLATA toll pool. Today the program provides support in exchange for reductions in intraLATA toll rates and switched access charges. The monthly per-line support level for each small, rural ILEC study area was determined in a one-time calculation using data from Fiscal Year 1997. Support per year to each carrier remains frozen as long as the carrier remains eligible.

The support consists of the sum of two hold-harmless calculations:

Toll pool revenue replacement. The intrastate toll pool was abolished in 1997. This support amount is the difference between the ILEC's toll pool revenue requirement during 1997 and its actual toll billed for 1997;

Access/toll rate reduction. If carriers reduced their carrier common line towards the interstate level, or if they reduced their "residual interconnection charge," or if they reduced intraLATA toll rates no higher than a \$0.20 cap, the lost revenue is replaced with support. The carrier may recover the difference between the previous rates and the new rates, computed on the basis of minutes of use in 1997.

The support is portable to competitive ETPs on a per-line basis. Each fund recipient must report eligible line account to the fund administrator on a monthly basis, and it must report its eligibility on an annual basis.

PURA §56.025 Support

This program was first adopted in 1995 and revised in 2005. An ILEC serving fewer than 31,000 access lines and telephone cooperatives can seek appropriate support if it experiences a revenue shortfall due to certain regulatory actions, including those affecting the commission's high cost fund, changes in federal USF, a change in the intraLATA access policy, or other governmental agency action.²⁵⁸ This program disburses \$4.5-4.7 million each year to 11 ILECs. No carrier has requested additional support since 1998.

Uncertificated Area

The commission can designate an ETP to provide voice services to permanent residential or business premises in areas where no carrier holds a certificate of convenience and necessity. ETPs can seek reimbursement for the actual cost of deploying new facilities as well as any recurring costs of providing service not recovered from customer revenue.²⁵⁹ The monthly per-line support is based on the average TUSF support received by adjacent ILECs.²⁶⁰ Since 2003, this program has disbursed a relatively small amount of support to four companies that serve about 229 lines in western Texas.

Successor Utilities

The 2003 revision to the PURA added this program for non-ILEC providers of last resort (POLR) to get support from TUSF. No ETP has requested support under this program.

²⁵⁸ Texas Admin. Code § 26.406.

²⁵⁹ Texas Admin. Code § 26.422.

²⁶⁰ Texas Admin. Code § 26.423.

Additional Financial Assistance

ILECs serving high-cost and rural areas in the state may request additional support if they can demonstrate a need.²⁶¹ This program ensures that ILECs facing competition continue to provide universal access to basic local telephones service at reasonable rates. No ETP has requested support under this program.

Solix, Inc. has been the contracted administrator of the TUSF since 1999 winning 2 separate bids (1999 and 2002). Solix processes fund collection and disbursement.

Although there are no statutory requirements for audits, the commission has initiated audits of the state Lifeline program at 25 companies. The audits did not lead to any findings of fraud. The commission plans to conduct audits of the high cost programs next.

References:

Texas Administrative Code. 26.401 through 26.424.

Public Utility Commission of Texas. 2007. Review and Evaluation of the Texas Universal Service Fund Pursuant to PURA Section 56.029. Available at http://www.puc.state.tx.us/telecomm/reports/TUSF/TUSF_Report_80thLeg.pdf

²⁶¹ Texas Admin. Code § 26.408.

Utah

The "Universal Public Telecommunications Service Support Fund" (the Utah USF) was established by statute in Utah in 1997. The fund, which in 2007 collected \$5.3 million, includes both high cost and Lifeline support, with high cost support comprising about \$4 million of the total fund. The Utah Public Service Commission established the fund and sets policy for its operation. The Utah Division of Public Utilities (DPU) serves as the fund administrator.

Telecommunication service providers, both wireline and wireless, pay into the fund; VoIP providers do not. Contributions are made through a percentage surcharge levied on intrastate retail sales revenue. Carriers recover the surcharge through a line item on customer bills. The surcharge has recently been lowered from 0.0045 percent to 0.0025 percent of billed intrastate retail rates. The smaller surcharge reflects an increased revenue base caused by growth in wireless service.

In order to qualify to receive USF support funds, a telecommunications corporation must be certified as both a federal eligible telecommunications carrier (ETC) and a state ETC. The public interest standard for state ETC designation is set high, especially for rural areas. At this time, the Utah Commission has not approved any competitive state ETC petitions for state high cost support.

A carrier seeking support from the fund must make a filing with the commission. The DPU then reviews the filing, which is much like a standard rate case; however the company's total revenue requirement is examined, not just its intrastate activities. The DPU calculates the carrier's total revenue requirement, applying the carrier's authorized intrastate rate of return. The DPU subtracts from revenue requirement the carrier's total revenues, both intrastate and interstate, as well as its federal universal service support. Support from the fund is equal to the difference. The rural ILECs in the state are proposing that support be calculated only in reference to intrastate revenue requirement and revenues, but no decision has been made.

To receive support from the Utah fund, carriers must charge at least a minimum rate for basic service, which currently is set at \$16.50 for residential and \$26.00 for business service. These affordable basic rates were established by the commission in 2005, after an examination of the national median rate and of regional averages. The commission can, by statute, establish different base rates for different study areas, but it has elected to set a single statewide base rate.

Once a carrier's support is established, it remains at the established level until the carrier requests a change in support level, or the DPU, in examining the carrier's annual reports, finds that the carrier has over-earned. Of the 15 rural local exchange carriers in the state, ten receive high cost support from the Utah USF. Qwest is under an alternative regulatory plan, and is the only ILEC under this plan at this time. Companies under this plan can request support from the fund. If they did apply, their requests would be evaluated through use of a cost proxy model rather than through an embedded cost study.

References:

Utah Code Annotated Title 54-8b-15

Public Service Commission Rules R746-360

Wisconsin

The Wisconsin state universal service fund (WUSF) provides support for a number of programs, including subsidies to low-income customers and to persons with disabilities, support for high-rate areas, subsidies for telemedicine equipment for hospitals and clinics, and support for public interest payphones. Wisconsin's high-rate assistance program provides support through customer credits. Rather than directly addressing carriers' costs, the high-rate assistance program focuses on keeping the rates actually charged to the subscribers at an affordable level.

Wisconsin's high rate assistance credit program was created on the state commission's initiative in 1990 and was later codified in the state Telecommunications Reform Act in 1993. The program – in its current form - began operation in 1996. Instead of subsidizing high loop costs directly, it provides subsidies for high-rate subscriber lines. The program compares the rate charged for a package of essential telephone services (including the federal subscriber line charge) to a benchmark rate and provides credits to buy down the rates of essential services that are above the benchmark rate. The package of essential telephone services includes a reasonably adequate number of calls within a reasonably adequate local calling area as defined by the commission. The adequate minutes determined depend on the size of the local calling area (See table in WI Administrative Code 160.09 (3)(c) for details). Currently the essential services package includes a maximum of 480 minutes of local calling minutes, access to 911, and a reasonable amount of long distance usage. DSL and advanced calling feature charges are excluded from the package. State statutes require that the Commission define a minimum data transmission speed, to be provided as part of essential services. The issue is now pending in the commission's Docket 1-AC-198. The Commission has determined that the new minimum data transmission speed will be 250kbps upstream and 750kbps downstream, but has not yet issued an order.

The benchmark above which the rates for an essential service are considered "high rates" is set at 1.5% of median household income by county. The credits increase as the telephone rates reach higher percentages of median household income. Credits are determined through the following table:

Portion of Rate -	Credit
< 1.5% of county median household income	0%
≥ 1.5% but < 2% of county median household income	50%
≥ 2% but < 2.5% of county median household income	75%
≥ 2.5% but < 3% of county median household income	85%
≥ 3% of county median household income	95%

Carriers that receive the state high rate assistance support must pass all the credits on to customers in their local bills.

The design of such a high-rate assistance program avoids resource-intensive and often times controversial cost studies. Instead of trying to get the cost calculation right, the commission staff focuses on making sure the subscriber rate is affordable. Its purpose is not to control rates but to ensure reasonable rate levels.

Intrastate wireline telecommunications providers pay into the WUSF, including ILECs, CLECs, IXCs and resellers. Wireless and CMRS providers also contribute. Fixed or interconnected VoIP providers are required to be certified in Wisconsin and they are required to contribute to the program, but nomadic VoIP providers are not.

The monthly assessment on gross intrastate revenue varies. The current rate, effective since October 2009, is 0.01570%. This assessment includes support to all PSCW programs funded through the WUSF. Providers can recover their contributions from subscribers through a line item on the customers' bills. Carriers with gross intrastate revenue below \$200,000 for the prior calendar year are exempt from contributing to the state fund.

The fund is administered by a third party, selected through a competitive bidding process. Currently the administrator is WIPFLI, LLP. State commission staff reviews the calculation of credits in light of changes in rates and county median income levels. The fund is audited by the Legislative Reference Bureau every year.

In the 2007-2008 fiscal year, \$6 million was collected for the state fund. Of that amount, \$87,496 was disbursed to eligible carriers through the high-rate assistance program, covering over 5,000 residential lines. The funding level is decreasing because the median household income in general is increasing while the telephone rates don't have a lot of upward increase. However, if inter-carrier compensation reform does occur, carriers may raise local rates, potentially triggering the benchmark for eligible support more often.

WUSF support is available to ILECs, CLECs and wireless providers. Carriers must be designated as ETCs to receive state funding (issues on ETC annual reporting requirements are now pending in commission docket 1-AC-198). Over the years, very few CLECs have withdrawn support from the fund because, in order to qualify for support, they have to price retail rates relatively high. This is not a likely scenario if they are in competition with ILECs.

Currently, several revisions to the state high rate assistance credit program are pending state commission action. The revisions include updates, clarifications and integration of new technologies.

Reference:

<http://psc.wi.gov/utilityinfo/tele/usf/usf-index.htm>

Wisconsin Administrative Code Chapter PSC 160

Wyoming

The Wyoming Public Service Commission has operated the Wyoming Universal Service Fund (WUSF) since 1997. The fund's primary support mechanism ensures that no Wyoming customer pays a rate for basic voice service greater than 130% of the weighted statewide average rate or "benchmark."

WUSF was authorized by a law enacted in 1995. That act set price floors that required each local exchange carrier to sell each service at a rate no lower than economic cost. The legislative purpose was to promote competition throughout the state, although wireline competition did not later develop extensively in Wyoming.

To implement the 1995 act, the commission required all companies to file cost studies. The studies estimated the costs of providing business service and residential service, as well as other LEC services, such as intraLATA toll and intrastate access. The studies were based on Total Service Long Run Incremental Cost (TSLRIC) principles. TSLRIC studies used proxy cost models. Qwest, which serves a large portion of the state, used its own cost model while other ILECs used commercially available models.

The new rates took effect in 1999 and 2000, with the overall effect being lower access rates²⁶² and higher local rates, particularly in rural areas. A few carriers adopted a unitary local rate for both business and residential customers. Qwest adopted three geographic rate zones, charging the highest local rate, \$69.35 per month, in its most rural areas. One rural LEC set a local rate at \$88.47 per month.

These high local rates provided the impetus for the WUSF to provide high cost support in the form of explicit credits on customer bills. WUSF credits eliminate 100% of any excess local rate above a fixed statewide benchmark. By statute, that benchmark is 130% of the weighted statewide average local rate. In 2009, the benchmark was \$32.57 per month for both residential and business customers. For example, a customer whose bill is \$32.00 per month would receive no credit. A customer with a bill of \$33 would get a credit of \$0.43. A customer with a bill of \$100 would get a credit of \$67.43. The WUSF reimburses carriers for all such credits granted to customers.

Customers who purchase bundled service packages also receive credits, but the credits are based on the rates paid by ILEC basic service customers. Similarly, the customers of a cable company or wireless company could receive credits if their rates were high enough to

²⁶² In 2007 the Wyoming legislature passed a new law that required further access reductions.

qualify.²⁶³ Currently, WUSF credits are provided and reimbursed only for the customers in ten ILECs. Approximately 17% of Wyoming's 238,000 lines receive WUSF support.

Wireless and competitive carriers (including cable voice customers) are theoretically eligible to receive support, but none actually does. In some cases these carriers have rates that are too low to generate credits. Others have decided not to participate in the WUSF program and have not filed the necessary annual reports. In several cases, a carrier reduced its actual rates to the benchmark and did not seek reimbursement. These carriers had so few lines exceeding the benchmark that the administrative cost of modifying customer bills would have exceeded the benefits.

The Wyoming statute requires the benchmark to be set at 130% of the state average rate for local service. The commission annually recalculates this benchmark.²⁶⁴ The calculations also include the cases of cable-voice customers, whose carriers do not sell basic service alone. The commission in these cases uses the ILEC rate in the same area to calculate the amount of the credit awarded to a cable-voice customer.

The WUSF operates on a fiscal year basis, using data reported after the end of the preceding calendar year. Supported carriers can ask for a mid-year adjustment of support. For example, if the FCC were to adopt a preemptive low rate for intrastate access, and if basic local rates were increased as a result, the commission could also increase the customer credit levels in mid-year. ILECs are generally losing lines in Wyoming, and this has generated some issues about lags in measuring line counts.

Wyoming carriers have an option to treat federal universal service support in either of two ways. In one option, federal support is shown as an explicit customer credit. In this option, the customer bill shows federal support as an explicit credit. The WUSF credit amount is based on the net amount, and the resulting WUSF credit becomes a second explicit credit on the bill. Qwest and one other carrier have chosen this option.

The second option is to treat federal USF payments as company revenue. In this option, the federal support implicitly reduces the local rate, and the WUSF credit is the only credit shown on the bill. Most Wyoming carriers use this option.

Most Wyoming carriers have not increased their rates since 2003. In 2007, the Wyoming legislature substantially changed the state's telecommunications law. The state commission lost all authority to set local rates based on rate-of-return principles. The legislation also required carriers to lower their intrastate access charges to \$0.03 or less, and allowed them to make up lost revenue by increasing rates for other charges, including basic local rates. As noted above,

²⁶³ The credit in that case would be based on the ILEC rate in the same area.

²⁶⁴ In calculating the statewide average rate, the commission includes data for customers who purchase voice service from cable providers. These customers are assumed to pay rates equal to the ILEC rates.

the chief ratemaking policy in Wyoming since 1995 has been that no rate may be below cost. In applying that rule, the state commission no longer uses TSLRIC principles to determine cost.

Wyoming rural companies offer broadband to a higher percentage of customers than Qwest. Rural LECs offer broadband to about 80 percent of their customers, and one rural LEC serves 100%. Qwest offers broadband to only about 60 percent of its customers.

WUSF funding is derived from a surcharge on intrastate telecommunications services. Cable-based VoIP providers also contribute to the fund, as do wireless providers. Wyoming statute prohibits requiring contributions from nomadic VoIP providers. The WUSF raised \$3.2 million in Fiscal Year 2008 with a surcharge rate of 1.0%. The WUSF surcharge is passed through and must be shown as a line item on customer bills.

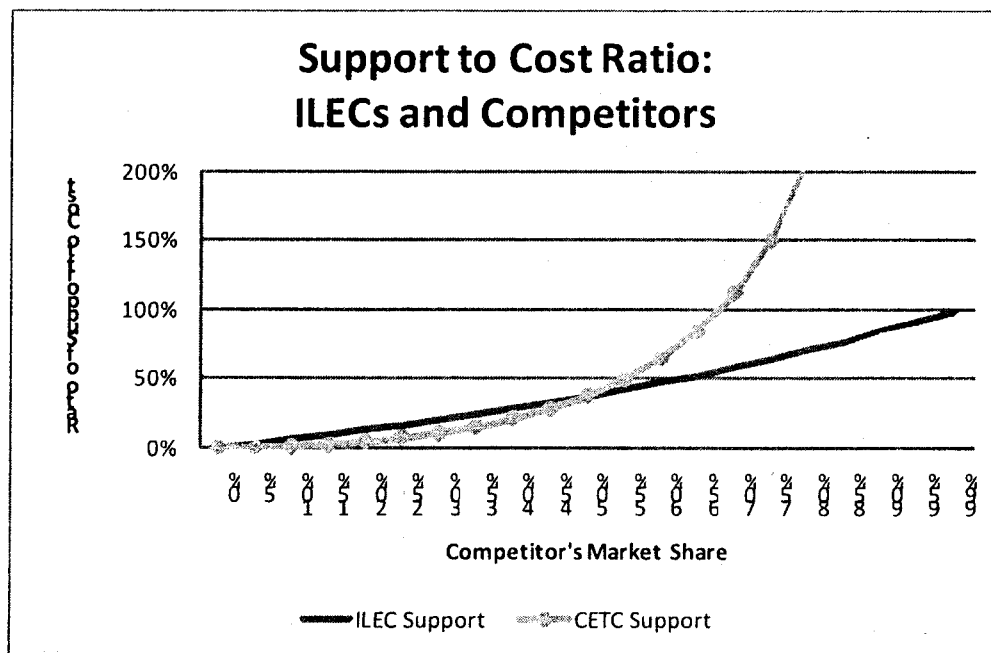
WUSF is scheduled for a legislative review in 2015. At that time, the state may address the continued need for regulation of essential services and for continuation of the fund.

Appendix C – Illustration of Effects of Identical Support Rule

Cost Assumptions:

1. ILEC cost for 10,000 customers is \$300,000 per month
2. ILEC costs are 60% fixed, 40% variable with subscribers.
3. CETC costs = 100% of ILEC cost.
4. Support = 100% x (Cost per line per month - \$30)

CETC Market Share	Lines	Monthly Cost	Cost per-line per month	USF Support per-line	USF Support	Net Cost per-line	Support / Cost
ILEC Business Case							
0%	10,000	300,000	30	-	\$ -	30	0%
10%	9,000	288,000	32	2	\$ 18,000	30	6%
50%	5,000	240,000	48	18	\$ 90,000	30	38%
70%	3,000	216,000	72	42	\$ 126,000	30	58%
90%	1,000	192,000	192	162	\$ 162,000	30	84%
CETC Business Case							
0%	-	180,000	N/A	-	\$ -	N/A	
10%	1,000	192,000	192	2	\$ 2,000	190	1%
50%	5,000	240,000	48	18	\$ 90,000	30	38%
70%	7,000	264,000	38	42	\$ 294,000	(4)	111%
90%	9,000	288,000	32	162	\$ 1,458,000	(130)	506%



Appendix D – Surcharges On All Retail Telecommunications Services

Most states that have high cost funds collect revenue by imposing surcharges on intrastate retail telecommunications services. This rule fits comfortably within the traditional scope of the rate supervision jurisdiction of state commissions. There are nevertheless several advantages to a broader surcharge on all retail telecommunications revenues.

- A broader base generates more revenue and may make some programs more effective. A narrow base requires a high rate for the same revenue. A state that limits itself to a surcharge solely on intrastate telecommunications services may not be able to generate sufficient revenue to address universal service issues comprehensively, including the urban-to-rural support flow.
- A broader base imposes fewer market distortions. If the state's surcharge rate is high and applies only to intrastate services, customers have an incentive to avoid consuming intrastate services. To the extent that customers have a choice of jurisdiction (such as when declaring the jurisdiction of special access circuits), they have an incentive to declare for the jurisdiction with lower surcharges.
- An intrastate-only surcharge perpetuates distinctions that are becoming antiquated in their original regulatory context. Traditionally the jurisdiction of a switched call was determined by the call's endpoints. Federal statute has now made those end points irrelevant for jurisdiction over wireless rates.²⁶⁵ Similarly, many voice calls now pass over the public Internet, which the FCC has declared an "interstate information service." Finally, the Supreme Court has declared that traditional regulatory distinctions do not apply to the pricing of unbundled network elements.²⁶⁶
- The intrastate revenue base is declining. Many states reported to us that their revenue bases are declining, in some cases by 5% per year.²⁶⁷ One cause is FCC preemption over some growing services such as DSL. In addition, the FCC has

²⁶⁵ States are wholly preempted from regulating rates for wireless calls, including intrastate calls. 47 U.S.C. § 332(c)(3)(A).

²⁶⁶ *AT&T Corp. v. Iowa Utilities Board*, 525 U.S. 366, 119 S.Ct. 721 (1999).

²⁶⁷ A few states reported no significant erosion of their intrastate revenue base, but these states tend to have expanding populations. Nevada is an example.

established a "safe harbor" percentage for VoIP services that allocates the majority of VoIP revenues to the interstate jurisdiction.²⁶⁸

- Similarity to taxes. State sales taxes on telecommunications services commonly are applied to both intrastate and interstate services. Aligning USF surcharges with state sales tax rules can simplify administration for carriers who collect the payments and for customers who are confused by complex retail bills.

Imposing a surcharge on interstate revenues creates legal risk. Several states that have imposed such a surcharge have lost in court. The following sections discuss the nature and extent of that legal risk.

1. State taxes and the Commerce Clause

As sovereign powers, the states have broad authority to impose taxes and fees to fund public programs. The Commerce Clause within the United States Constitution sets limits on state taxes imposed on interstate commerce.

State ability to tax interstate telecommunications services was upheld in the Supreme Court in the 1989 case of *Goldberg v. Sweet*.²⁶⁹ In 1984, Illinois enacted a 5% excise tax on the gross charge for interstate and intrastate telecommunications originated or terminated in that state.²⁷⁰ The tax applied only to calls that were charged to an Illinois service address, regardless of where the monthly bill was sent to or paid from. Taxpayers and a telecommunications carrier challenged the statute as violating the Commerce Clause.

Over the years, the Supreme Court had decided many cases involving the Commerce Clause and state taxes. The Court had noted a basic tension between the view that interstate commerce enjoys a "free trade" immunity from state taxation and the view that businesses engaged in interstate commerce may be required to pay their own way. The Court had developed a four-part test to evaluate such Commerce Clause challenges.²⁷¹ In the Illinois case, the Court concluded that the tax satisfied that four-part test.

The first prong of the constitutional test is whether the tax has a substantial nexus with the state. For a telecommunications tax, the Court stated that only two states could satisfy that test. The first was a State that taxed the origination or termination of an interstate telephone call

²⁶⁸ The interstate safe harbor for interconnected VoIP services is 64.9%. See <http://www.fcc.gov/Forms/Form499-A/499a-2008.pdf> at 14.

²⁶⁹ *Goldberg v. Sweet*, 488 U.S. 252 (1989).

²⁷⁰ See 35 Ill. Comp. Stat. § 630 (Telecommunications Excise Tax Act). The current rate is 7%.

²⁷¹ *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 278-79 (1977).

charged to a service address within that State. The second was a State that taxed the origination or termination of an interstate telephone call *billed to or paid from* within that State.²⁷² The nexus issue was not disputed in the Illinois case because the tax was of the first type.²⁷³

The second prong of the constitutional test is whether the tax is "fairly apportioned." This requirement aims to ensure that each state's tax applies to only a "fair share" of an interstate transaction. The court does not impose a single method of apportionment, a task that it considers more appropriate for a legislature than a court. Instead, the court examines whether the tax is internally and externally consistent.²⁷⁴

A tax is internally consistent if it is structured in such a way that no multiple taxation would occur even if every state were to impose an identical tax. The Illinois tax met this test because if every State taxed interstate phone calls charged to an in-state service address, only one State would tax each interstate telephone call, the state with the service address.

A tax is externally consistent if the State taxes only that portion of the revenues from the interstate activity which reasonably reflects the in-state component of the activity being taxed. The Illinois tax applied the full charge to interstate calls with an Illinois service address, even though such a call triggers simultaneous activity in several States. The Court upheld the Illinois tax on the ground that, like sales taxes, this telecommunications tax reasonably reflected the way that consumers purchased interstate telephone calls.²⁷⁵ The Court did note the possibility of double taxation if a customer had a service address in Illinois and a billing address in another state. However, it concluded that the Illinois statute was a "realistic legislative solution" to the difficulties of apportioning telephone mileage.²⁷⁶ Moreover, Illinois allowed such customers to seek a refund of taxes paid in other states and thus avoided any risk of "actual multiple taxation." The Court held the Illinois tax was fairly apportioned because its economic effect was like that of a sales tax, the risk of multiple taxation was low and any multiple taxation problems could be solved by the statutory credit provision.²⁷⁷

The third prong of the constitutional test is whether the tax discriminates against interstate commerce. Such discrimination may be explicit or through its economic effect. For example, a flat per-truck tax on trucks passing through a state can discriminate against interstate

²⁷² *Id.* at 263.

²⁷³ *Id.* at 260.

²⁷⁴ *Id.* at 261.

²⁷⁵ *Id.* at 261-63. By contrast, a state through which a call passes but which has no other contacts with a call probably would not satisfy the nexus requirement and could not tax the call.

²⁷⁶ *Id.* at 265.

²⁷⁷ *Id.* at 264.

truckers who might travel relatively few miles in the state.²⁷⁸ The Court upheld the Illinois telecommunications tax, however, because the economic burden of the Illinois tax fell on Illinois telecommunications consumers, whom the Court thought were "able to complain about and change the tax through the Illinois political process." In addition, the Court held that in a modern telecommunications network it is impossible to trace and record the exact path of the signals. A more precise approach was impossible.²⁷⁹

The fourth and final prong of the constitutional test is whether the tax is fairly related to services which the state provided to taxpayers. This test aims to ensure that a State's tax burden is not placed upon persons who do not benefit from services provided by the State. Nevertheless, the Court was willing to look at a wide range of benefits provided to taxpayer, not just the precise activity connected to interstate activity at issue. The Court concluded that the Illinois tax complied with this test because the revenues helped pay for benefits to Illinois subscribers who receive general government services, including fire and police protection.²⁸⁰

Overall, the *Goldberg v. Sweet* decision suggests that states have constitutional room to support their universal service programs from surcharges structured to operate in the same manner as the Illinois Excise Tax. To the extent that state considers this option, matching the details of that Illinois law would be advisable, a matter discussed in more detail below.

2. Universal service surcharges and TA96

When TA96 passed, several states already had universal service programs. For example, Vermont enacted a statute in 1994 that created a universal service fund based on a surcharge on both intrastate and interstate telecommunications services.

Section 254 of TA96 was the first codification of universal service in federal statutory law. It stated goals for universal service and authorized federal programs and fund collections. It also authorized state universal service programs. Subsection 254(f) is shown below. For better reference, numbers have been assigned to each sentence.

(f) State authority. (1) A State may adopt regulations not inconsistent with the Commission's rules to preserve and advance universal service. (2) Every telecommunications carrier that provides intrastate telecommunications services shall contribute, on an equitable and nondiscriminatory basis, in a manner determined by the State to the preservation and advancement of universal service in that State. (3) A State may adopt regulations to provide for additional definitions and standards to preserve and advance universal service within that State only to the extent that such regulations adopt additional specific,

²⁷⁸ *American Trucking Associations, Inc. v. Scheiner*, 483 U.S. 266 (1987).

²⁷⁹ *Goldberg v. Sweet*, 266.

²⁸⁰ *Id.* at 267.

predictable, and sufficient mechanisms to support such definitions or standards that do not rely on or burden Federal universal service support mechanisms.²⁸¹

This statute is extraordinary in several respects. The basic problem is that Congress never explained why subsection (f) was needed at all. If the purpose was to authorize state universal service programs, states already had clear authority in 1996 to tax their citizens for purposes of universal service. In 1989 the Supreme Court had even upheld the Illinois Telecommunications Sales Tax, which provided general revenue for that state's government. Perhaps Congress was misinformed about the extent of state authority and the need to create such authority. Perhaps Congress was really trying to limit such programs in the guise of enabling them.

Second, subsection 254(f) adopted vague restrictions on state funds that have been difficult to interpret. One portion of 254(f) is clear: the part that identifies *which* providers must contribute. Carriers may be made to contribute if they provide intrastate telecommunications services.²⁸² Yet the statute says nothing explicitly regarding *how much* these carriers can be required to contribute or the allowable bases upon which any surcharges may be imposed. Instead, the second sentence of (f) merely says that the contributions must be "equitable and nondiscriminatory."

The third sentence of (f) has additional restrictions. It is confusing both in its terminology and its syntax. It states that any state "mechanism" must be "specific, predictable and sufficient." It is not clear what Congress meant by a "mechanism," particularly as to whether it means only fund distribution rules or also fund collection rules. Although the syntax is unclear, the final clause of 254(f) seems to say that a state's mechanism for universal service may not "rely on or burden" any federal mechanism. It does not explain what such a prohibited reliance or burden might look like. More specifically, it does not say whether states are prohibited from imposing surcharges on the same economic activities and services as federal universal service programs.

These ambiguities have led to litigation. The Fifth Circuit Court of Appeals has repeatedly interpreted subsections 254(d) and (f) in ways that constrain state universal service program fund collection rules. The first case involved federal programs. Soon after TA96 was enacted, the FCC issued a long interpretive order. The FCC claimed authority to calculate contribution requirements for some universal service programs based on the total amount of a carrier's telecommunications services revenues, rather than merely its interstate services. On appeal, the Fifth Circuit reversed, holding that contributions required under subsection 254(d) of

²⁸¹ 47 U.S.C. § 254(f) (sentence numbers added).

²⁸² This sentence complements parallel language in subsection 254(d) authorizing the FCC to collect contribution for its own universal service programs from "every telecommunications carrier that provides *interstate* telecommunications services." 47 U.S.C. § 254(d) (emphasis added).

TA96 cannot include the carrier's intrastate revenues.²⁸³ The effect was to limit the FCC's revenue base for universal service to interstate telecommunications revenues.²⁸⁴

The relevant question for state commissions is the mirror question: is the revenue base for state universal service programs limited to intrastate services? There have been three relevant court decisions, two in federal courts and one in state court. The results conflict.

Texas established a 3.6% universal service surcharge that applied only to carriers providing intrastate services. Texas applied the surcharge to both intrastate and interstate revenues. AT&T challenged the statute, and the case reached the Fifth Circuit. The court's analysis hypothesized two carriers. If carrier A provided only interstate services in Texas, it would not pay a state surcharge, but it would pay the FCC's universal service surcharge of 7.28% (at that time) on its interstate revenues. By contrast, if carrier B provided both interstate and intrastate services in Texas, it would have to pay not only the federal 7.28% surcharge on interstate revenue but also Texas's 3.6% surcharge for a total surcharge of 11%. This higher rate, the court concluded, was "discriminatory and inequitable" and therefore a violation of the second sentence of subsection 254(f). In sum, the court held that since TA96 placed carrier A beyond the taxable reach of the state, any state surcharge on B could not be based on interstate revenues.²⁸⁵

In an earlier Oregon case, *AT&T v. Eachus*, a different federal court reached a similar result, but for completely different reasons. Oregon had imposed a surcharge on intrastate and interstate telecommunications services provided to an Oregon service address. The Oregon court found that this charge "relied on" federal mechanisms, in violation of the third sentence of 254(f).²⁸⁶ The court explained:

The ordinary meaning of "rely on" encompasses "depends on." Thus, where the Commission's regulations 'depend on' the same interstate revenues utilized by the federal universal service fund program, it improperly "relies on" federal universal service support mechanisms.²⁸⁷

²⁸³ *Texas Ofc. of Public Utility Counsel v. FCC*, 183 F.3d 393 (1999).

²⁸⁴ The FCC did not ask the Supreme Court to review this decision. The decision is binding on the FCC and other parties, probably binding on states within the Fifth Circuit and persuasive elsewhere.

²⁸⁵ *AT&T v. Public Utility Comm'n of Texas*, 373 F.3d 641 (2004). The court did not reach other possible objections to the Texas surcharge, such as whether it would rely on or burden federal mechanisms, in violation of the third sentence of subsection 254(f).

²⁸⁶ *AT&T Commun. Inc. v. Eachus*, 174 F.Supp. 1119 (D. Oregon, 2001).

²⁸⁷ *Id.* at 1124.

The Oregon court also found that the Oregon surcharge improperly burdened the federal collection mechanism that assesses interstate revenue, also in violation of the third sentence of 254(f). The court explained that because the Oregon surcharge relied "on interstate revenues also assessed to contribute to the federal universal support fund, it burden[ed] federal universal support mechanisms."²⁸⁸ Notably, the Oregon court also held that the Oregon surcharge was not inequitable or discriminatory, thereby disagreeing with the conclusion later reached by the Fifth Circuit.

A third court decision reached the opposite result and sustained a surcharge imposed by South Carolina on both interstate and intrastate telecommunications revenues. Competitive providers and cable providers challenged the enactment on the ground that it burdened federal universal service support mechanisms. The South Carolina Supreme Court upheld the surcharge.²⁸⁹ While the court did acknowledge that the state's surcharge on interstate service did burden interstate carriers, the court drew a distinction between a burden on carriers and a burden on federal support mechanisms, finding that they were "not necessarily synonymous."²⁹⁰ While the South Carolina surcharge did impose on interstate carriers, the court found no imposition on federal mechanisms.

3. Conclusion

The safer legal course is clear. If a state wants to impose universal service surcharges only on intrastate revenues with a nexus to that state, a legal challenge is unlikely.

On the other hand, a state has numerous substantive reasons to take some legal risk, particularly since the applicable law remains unclear. Of the three courts that have reviewed the matter, one sustained the state law and two invalidated the state law. There is no consensus about the relevant legal standards, but there are constitutional and statutory reasons to be optimistic, provided that the state takes suitable precautions.

A state that decides to impose a surcharge on interstate retail telecommunications revenues should take the following steps to minimize legal risk.

1. Enact the surcharge in state legislation. This legislation can articulate the state's intention to exercise its sovereign power to impose taxes. The legislation can expressly disavow any intention of relying on authority delegated subsection 254(f) of the Communications Act. The legislation might also include findings regarding why the state deems a surcharge on interstate services necessary to generate sufficient universal service funding.

²⁸⁸ *Id.* at 1124-25.

²⁸⁹ *Office of Regulatory Staff v. Public Service Comm'n.*, 647 SE.2d 223 (S.C. 2007).

²⁹⁰ *Id.* at 231.

2. Consolidate the universal service surcharge with other state telecommunications surcharges, sales taxes or excise taxes. This measure also demonstrates that the state is exercising its sovereign taxing power and broadens the debate to cover more than merely universal service as contemplated in section 254 of TA96. To the extent that a state's surcharges aim to solve a range of telecommunications problems broader than those recognized in 254(f), a court would be less inclined to conclude that the vague restrictions in that subsection invalidate the state's programs. For example, if a state were to use a single fund to finance high cost funding, Lifeline, Relay and Enhanced 911, it would be more difficult for a challenger to prove that such a fund is limited by subsection 254(f). To further accentuate the distinction the state might avoid using the title "universal service fund" and use a broader title not associated merely with high cost programs, such as "communications access fund."
3. Exempt carriers that engage only in interstate telecommunications services in the state. This safeguard complies with the clear language of subsection 254(f), should it be held applicable.
4. Allow carriers that provide a *de minimis* amount of intrastate services to receive a waiver of the state surcharge or pay a reduced surcharge that is no larger than their intrastate revenues.²⁹¹
5. Apply the same surcharge rate for intrastate and interstate telecommunications services. This avoids problems under the Commerce Clause and at least nominally satisfies the equitable and nondiscriminatory requirement of 254(f).
6. Ensure that surcharges apply only to telecommunications services with a sufficient nexus to the state. One safe course would be to limit the surcharge to telecommunications services where:
 - a. At least one participant is in the state (originating or terminating party for a switched service or a channel termination for a point-to-point service); and

²⁹¹ In a 1999 decision, the Fifth Circuit found that a satellite company, COMSAT, derived such a small portion of its revenues from interstate service that its federal universal service payments would have exceeded its interstate revenues. The Fifth Circuit held that such an arrangement was not equitable because it imposed prohibitive costs on COMSAT. *See Texas Ofc. of Public Utility Counsel v. FCC*, 183 F.3d 393 (1999). If a state's law made provision reducing the risk that a very small amount of intrastate revenue could generate a large surcharge, that provision would reduce the risk that the state's surcharge might be held to violate subsection 254(f).

b. The service is provided to a service address or billing address or place of primary use in the state. For mobile telecommunications services, this test should be stated as whether the customer's place of primary use is in the state.²⁹²

7. Allow taxpayers to claim refunds if they have paid similar universal service taxes or surcharges in another state.

²⁹² See Pub. L. 106-252, Sec. 3 (codified at 4 U.S.C. § 116-126). This 2000 federal law, called the "Mobile Telecommunications Sourcing Act," limits state authority impose taxes on mobile telecommunications. The act does not nominally apply if the sole purpose of the state's surcharge is universal service, *see* 4 U.S.C. § 116(b)(5), but it would apply if the state's enactment included other purposes.



BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS

KRISTIN K. MAYES, Chairman
GARY PIERCE
PAUL NEWMAN
SANDRA D. KENNEDY
BOB STUMP

IN THE MATTER OF THE REVIEW AND
POSSIBLE REVISION OF ARIZONA
UNIVERSAL SERVICE FUND RULES,
ARTICLE 12 OF THE ARIZONA
ADMINISTRATIVE CODE.

DOCKET NO. RT-00000H-97-0137

IN THE MATTER OF THE INVESTIGATION OF
THE COST OF TELECOMMUNICATIONS
ACCESS.

DOCKET NO. T-00000D-00-0672

**REJOINDER TESTIMONY OF
DOUGLAS DUNCAN MEREDITH
ON BEHALF OF
THE ARIZONA LOCAL EXCHANGE
CARRIERS ASSOCIATION**

I INTRODUCTION

**Q: ARE YOU THE SAME DOUGLAS DUNCAN MEREDITH WHO PREVIOUSLY
SUBMITTED TESTIMONY IN THESE DOCKETS?**

A: Yes.

**Q: WHAT ISSUES WOULD YOU LIKE TO ADDRESS IN YOUR BRIEF
REJOINDER TESTIMONY?**

A: I would like to respond briefly to three issues raised by Qwest, AT&T, and Sprint. Please
note that my silence on other issues raised in reply testimony does not mean that I agree
with any position taken on those issues. Rather, I believe the record is sufficiently clear
for the Commission to judge those issues without additional rejoinder testimony.

**Q: QWEST HAS SUGGESTED THAT ALECA'S HIGH-COST LOOP PROPOSAL
WOULD LEAD TO DOUBLE RECOVERY OF LOOP COSTS;¹ IS THIS
ALECA'S INTENT?**

A: No. The ALECA proposal was designed to provide additional support for unreimbursed
loop costs exceeding the 115 percent national average. See proposed Rule R14-2-
1202(A). Under the proposed rule, only unreimbursed costs in excess of 115 percent of
the national average cost per loop are eligible for consideration.

After reading Mr. Copeland's testimony, I do agree that a clarification should be made in
the rule to explicitly state that a percentage of costs in excess of 115 percent of the
national average are reimbursed through the programs in the interstate jurisdiction.
Therefore, I recommend the rule explicitly include the statement: "Such amount shall
account for the allocation of loop costs assigned to and recovered or reimbursed in the
interstate jurisdiction."

¹ Copeland Reply Testimony at 8-9.

1 This addition to the proposed rule would prevent double recovery of costs in excess of
2 the 115 percent threshold.

3 **Q: AT&T SUGGESTS THAT MOVING TO INTERSTATE RATES WOULD BE**
4 **EASIER RATHER THAN USING QWEST'S RATE AS A COMPOSITE**
5 **TARGET;² DO YOU AGREE?**

6 **A:** No. The mirroring process proposed by AT&T would not be easier because the rate
7 elements and rate structure used in the interstate jurisdiction differ from the rate elements
8 and rate structure used in the state jurisdiction. The ALECA proposal recognizes these
9 differences and recommends a Qwest-based composite target of \$0.022 per minute of use
10 for state switched access service. Under this proposal, each ALECA member would
11 reduce its current state access tariff rates to reach this composite per-minute-of-use target.
12 This is a very sound and conservative first step that does not require a change of the
13 structure of each ALECA state access tariff. I also note that the proposed rule R14-2-
14 1202(A) (F) contemplates future access reductions as determined by the Commission.
15 Thus, I continue to recommend the Commission take the recommended first step in state
16 access reduction and use the Qwest composite target rate.

17 **Q: WHAT DO YOU THINK OF SPRINT'S SUGGESTION THAT NON-**
18 **REGULATED REVENUES SHOULD BE USED TO OFFSET REGULATED**
19 **REVENUES LOST DUE TO STATE ACCESS REFORM?³**

20 **A:** I recommend the Commission reject this suggestion. The fact that ALECA members
21 provide bundles that include non-regulated services is not relevant in this proceeding.
22 Cross-subsidization of services is a violation of ACC rule R14-2-1109 (C). The ALECA
23 companies comply with FCC Part 64 that ensures the proper assignment of cost between

² Aron Reply Testimony at 62-63.

³ Appleby Reply Testimony at 17:1-5.

1 regulated and non-regulated activities. Non-regulated operations should not be used to
2 subsidize regulated operations, just as regulated operations should not subsidize non-
3 regulated operations.

4 Aside from the fact that cross-subsidization is a violation of ACC rules, many of the
5 bundled services offered by ALECA members may include products that are "break-
6 even" with regard to profitability. Sprint points out revenue opportunities for some
7 ALECA members far exceed their basic local voice revenue streams; however, the costs
8 of these opportunities are not considered in Sprint's analysis. I recommend the
9 Commission reject this proposal.

10 **Q: DOES THIS END YOUR PRE-FILED REJOINDER TESTIMONY?**

11 **A:** Yes.

BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS

KRISTIN K. MAYES, Chairman
GARY PIERCE
PAUL NEWMAN
SANDRA D. KENNEDY
BOB STUMP

**IN THE MATTER OF THE REVIEW AND
POSSIBLE REVISION OF ARIZONA
UNIVERSAL SERVICE FUND RULES,
ARTICLE 12 OF THE ARIZONA
ADMINISTRATIVE CODE.**

DOCKET NO. RT-00000H-97-0137

**IN THE MATTER OF THE
INVESTIGATION OF THE COST OF
TELECOMMUNICATIONS
ACCESS.**

DOCKET NO. T-00000D-00-0672

DIRECT TESTIMONY

OF

DOUGLAS DENNEY

ON BEHALF OF

**Eschelon Telecom of Arizona, Inc.; Mountain Telecommunications, Inc.; Electric
Lightwave, LLC; McLeodUSA Telecommunications Services, Inc. d/b/a PAETEC Business
Services; tw telecom of arizona llc; and XO Communications Services, Inc.**

December 1, 2009

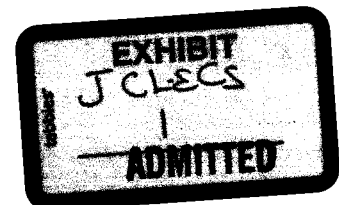


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1 **I. INTRODUCTION**

2 **Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.**

3 A. My name is Douglas Denney. I work at 1201 NE Lloyd Boulevard, Suite 500,
4 Portland, Oregon.

5 **Q. BY WHOM ARE YOU EMPLOYED AND IN WHAT CAPACITY?**

6 A. I am Integra Telecom's Director of Costs and Policy. My responsibilities include
7 negotiating interconnection agreements, monitoring, reviewing and analyzing the
8 wholesale costs that Integra Telecom and its affiliates, including Eschelon
9 Telecom of Arizona, Inc., Mountain Telecommunications, Inc., and Electric
10 Lightwave, LLC,¹ pay to carriers such as Qwest, AT&T and Verizon. In addition,
11 I have been involved in policy issues surrounding interstate and intrastate
12 switched access, including filing comments with the FCC regarding its review of
13 intercarrier compensation.²

14 **Q. ON WHOSE BEHALF ARE YOU TESTIFYING?**

15 A. I am testifying on behalf of Integra, McLeodUSA Telecommunications Services,
16 Inc. d/b/a PAETEC Business Services, tw telecom of arizona llc and XO

¹ I will generally refer to the separate Integra Telecom entities in Arizona as Integra.

² *Comments of Integra Telecom, Inc.*, In the Matter of High-Cost Universal Service Support, Federal-State Joint Board on Universal Service, Lifeline and Link Up, Universal Service Contribution Methodology, Implementation of the Local Competition Provisions in the Telecommunications Act of 1996, Developing a Unified Intercarrier Compensation Regime, Intercarrier Compensation for ISP-Boand Traffic, IP-Enabled Services, and Number Resource Optimization, Docket Nos. WC 05-337, CC 96-45, WC 03-109, WC 06-122, CC 96-98, CC 01-92, CC 99-68, MG 04-36, and CC 99-200 ("FCC Intercarrier Compensation Docket"), November 26, 2008.

1 Communications Services, Inc. (collectively, "Joint Competitive Local Exchange
2 Carriers" or "Joint CLECs").

3 **Q. PLEASE DESCRIBE YOUR EDUCATION AND PROFESSIONAL**
4 **BACKGROUND.**

5 A. I received a B.S. degree in Business Management from Phillips University in
6 1988. I spent three years doing graduate work at the University of Arizona in
7 Economics, and then I transferred to Oregon State University, where I completed
8 all the requirements for a Ph.D. except my dissertation. My field of study was
9 Industrial Organization, and I focused on cost models and the measurement of
10 market power. I taught a variety of economics courses at the University of
11 Arizona and Oregon State University. I was hired by AT&T in December 1996
12 and spent most of my time with AT&T analyzing cost models, including the cost
13 of switched access. While at AT&T I worked in the access cost management
14 organization in the western region (the region that includes Arizona and thirteen
15 other Qwest's states). The primary focus of this organization was to achieve
16 access rate reductions across the states in the Qwest region. In December 2004, I
17 was hired by Eschelon Telecom, Inc., which was subsequently purchased by
18 Integra Telecom, where I am presently employed.

19 I have participated in more than 40 proceedings in the 14-state Qwest region. I
20 testified, for example, as a witness in a recent arbitration proceeding to determine
21 the terms of the contract, known as an interconnection agreement ("ICA"),

1 between Qwest and Eschelon in Arizona Docket Nos. T-03406A-06-0572 and T-
2 01051B-06-0572,³ as well as the Qwest-Eschelon ICA arbitration proceedings in
3 Colorado, Minnesota, Oregon, Utah, and Washington. I participated in the
4 underlying ICA negotiations, as well as the arbitrations. I have also testified
5 about issues relating to wholesale service quality (including Performance
6 Indicator Definitions and Performance Assurance Plans) and the wholesale cost of
7 local service (including universal service funding, unbundled network element
8 ("UNE") pricing, geographic deaveraging of UNE prices, and competitive local
9 exchange carrier ("CLEC") access rates).

10 **Q. HAVE YOU PREVIOUSLY TESTIFIED IN ARIZONA?**

11 A. Yes. When with AT&T, I testified in multiple phases of docket T-00000A-00-
12 0194: I testified on geographic deaveraging in Phase I. In Phase II, I supported
13 the HAI Model, which this Commission adopted to set many of the recurring
14 UNE rates in place today. In Phase IIa, I testified about the switching costs
15 included in the HAI Model. I also filed testimony in docket T-00000A-03-0369,
16 the original Triennial Review Order ("TRO") docket, which was stopped after the
17 D.C. Circuit Court remanded parts of the TRO to the FCC. Since I have been
18 with Eschelon, I presented oral comments in docket T-00000I-04-0749 regarding
19 the current state of competition. Most recently, besides the Eschelon-Qwest

³ *In the Matter of the Petition of Eschelon Telecom of Arizona, Inc., for Arbitration with Qwest Corp., Pursuant to 47 U.S.C. Section 252 of the Federal Telecommunications Act of 1996, Docket Nos. T-03406A-06-0572 and T-01051B-060572 ("Qwest-Eschelon Arizona Arbitration").*

1 arbitrations mentioned previously, I filed testimony in docket T-03632A-06-0091
2 on behalf of a number of CLECs addressing key UNE issues arising from the
3 Triennial Review Remand Order, including a review of Qwest's list of Arizona
4 non-impaired wire centers. I also presented oral comments on behalf of Integra at
5 the intrastate access cost workshop associated with this docket, which was held on
6 June 19, 2009.

7 **Q. HOW IS YOUR TESTIMONY ORGANIZED?**

8 A. My testimony is organized by issue number as contained in the September 29,
9 2009 Procedural Order.⁴

10 **Q. DO YOU HAVE ANY GENERAL OBSERVATIONS ABOUT THIS**
11 **PROCEEDING?**

12 A. Yes, I have two observations. First, the Commission should carefully scrutinize
13 the motivations behind the various party recommendations in this docket as the
14 decisions made here can radically alter the industry landscape. For example,
15 Rural ILECs, faced with a continued reduction of access lines and access minutes
16 are glad to replace a falling revenue stream for a more "reliable" source such as a
17 Universal Service Fund ("USF"), much of which would be funded by end users of
18 other local exchange carriers. IXC's such as AT&T and Verizon are simply
19 attempting to reduce the dollars they pay to carriers in Arizona, reducing the cost
20 of their long distance services. With the merger of the largest ILECs with the

⁴ *Procedural Order*, September 29, 2009, pp. 4-5.

1 largest Interexchange Carriers (“IXCs”) (i.e. AT&T and Verizon), the disparate
2 voices on switched access rates have turned into a chorus for “reform” that is
3 primarily an attempt by the largest payers of access to reduce their expenses to the
4 detriment of Arizona’s local exchange companies (“LECs” – both ILECs and
5 CLECs) and their end-user customers in Arizona. The large IXCs propose to
6 virtually eliminate what they pay today to carriers serving Arizona end-users
7 without any promise of benefit to the Arizona end-users. If the proposals of large
8 IXCs are adopted, their cost reductions will come at the expense of Arizona end-
9 users. CLECs simply request that the Commission refrain from radical change
10 that would force CLECs to alter business plans that they have been implementing
11 over the past ten plus years. CLECs operate in a competitive market that has
12 already been excessively turbulent due to regulatory change, crisis of financial
13 markets and continuous litigation, but CLECs, unlike ILECs, have no prospect of
14 a safe harbor in USF funding.

15 Second, the Commission should bring a historical perspective to its analysis of the
16 issues in this docket. The Commission should be cautious of taking the radical
17 step of price regulating CLECs – small players in the market whose existence is
18 due to the pro-competitive provisions of the Telecommunications Act of 1996. A
19 decision to *price regulate CLECs* would be exceedingly ironic given that the
20 policies that gave birth to CLECs were intended to reduce price regulation.
21 Further, price regulating CLECs would also run counter to (1) the continuing
22 deregulation of the incumbent local exchange carriers (“ILECs”) in both retail and

1 wholesale markets; (2) the Regional Bell Operating Companies ("RBOCs") entry
2 into long distance markets; (3) the lightly regulated megamergers of the largest
3 RBOCs with the largest IXC; and (4) the emergence of intermodal competition
4 between landline, cable and wireless companies.

5 **Q. PLEASE SUMMARIZE YOUR TESTIMONY.**

6 **A.** This Commission faces a number of decisions regarding potential changes to
7 intrastate switched access rates. Overlying each of these decisions should be a
8 clear understanding of the impact of these decisions on end-user customers in
9 Arizona, as well the winners and losers created by each determination.

10 First and foremost, the Commission must decide *which carriers* will fall under
11 mandated changes to intrastate switched access rates.⁵ There is universal
12 agreement and a strong desire among the rural carriers that rural carrier access
13 rates be addressed. Disparate opinions emerge regarding the question as to
14 whether Qwest or CLEC intrastate switched access rates should also be reviewed
15 at this time. The Joint CLECs, who pale in size,⁶ and thus resources, when
16 compared with the large IXCs and ILECs (AT&T, Verizon and Qwest) prefer that
17 this debate not take place in multiple venues simultaneously. The FCC is intent

⁵ Because this proceeding is to address intrastate switched access rates, for the purpose of this testimony I will generally refer to these rates as access rates (or access charges) for simplicity. The term "access rates" generally refers to a wide range of rates in addition to intrastate switched access. In cases when I am discussing *interstate* switched access rates or *special* access (private line) rates, I will attempt to make the distinction clear.

⁶ See table 3 for a comparison of the annual revenues of the Joint CLECs with the annual revenues of AT&T, Verizon and Qwest.

1 on addressing intercarrier compensation,⁷ including potentially intrastate switched
2 access as the large IXC's (AT&T and Verizon) have made significant headway in
3 convincing the FCC to take jurisdiction away from the states. While the large
4 IXC's can afford to press their concerns in every forum available to them in order
5 to achieve additional earnings for their shareholders (through access reduction),
6 the Joint CLECs prefer not to spend scarce financial resources on multiple and
7 potentially duplicative access proceedings. The cost of a proceeding to review
8 access charges and implement possible changes would likely far exceed the
9 benefit of doing so. In fact, CLECs will bear costs grossly disproportionate to
10 their revenues compared to other parties without any prospect of a benefit. From
11 the perspective of Arizona's end-user customers, the regulatory apparatus
12 intended to protect them, will be misused in a shell game that transfers resources
13 from small LECs and Arizona end users to the large IXC's. There is no pressing
14 need to take any action on CLEC access charges at this time and every reason not
15 to.

16 Second, once the Commission decides what classes of carriers will be involved in
17 changes to access rates, it must decide on the *targeted levels* (benchmarks) for
18 new access rates. The decision essentially boils down to whether the Commission
19 will implement access rate reductions based on (a) a carrier's cost or (b) an
20 arbitrary rate such as interstate switched access rates or Qwest's intrastate

⁷ Intercarrier compensation would potentially address all forms of payments between carriers for the exchange of traffic, including reciprocal compensation, interstate switched access and intrastate switched access.

1 switched access rates. Both interstate switched access rates and Qwest intrastate
2 switched access rates are arbitrary targets for CLECs because neither was
3 established based on any carrier's cost, much less any CLEC's cost. Instead,
4 these rates were the result of deals reached between selected carriers, to their own
5 benefit, without regard to cost, let alone carrier-specific costs. Applying rates
6 developed for the benefit of one specific group of carrier's (such as large ILECs)
7 to another group of carriers, such as CLECs, that typically were neither involved
8 in the development of those rates, nor could foresee that years later results of
9 these negotiations would potentially be forced onto them, is arbitrary and
10 fundamentally unfair. Joint CLECs believe that cost is the only fair benchmark.⁸
11 Yet, if this Commission does decide to mandate CLEC access rate reductions with
12 a target other than cost, then the Commission should establish a benchmark rate
13 equal to Qwest's intrastate switched access rates from the 1999 time period. This
14 is the time period when most CLECs were entering the competitive market and
15 was before Qwest entered into negotiated, revenue neutral, access reductions for
16 its own benefit as a result of the price cap proceedings.

17 Third, once the set of carriers to which reductions access rates will apply is
18 established and a target rate is selected, the Commission must determine the
19 *transition* process from current access rates to the target rates. AT&T proposes

⁸ This recommendation is consistent with position of this Commission, which stated, "The Arizona Commission does not support the adoption of a one-size-fits-all approach with respect to the establishment of reciprocal compensation rates. The rates established by the state commission should reflect the costs of providing the service for the particular carriers involved." Reply Comments of the Arizona Corporation Commission, FCC Inter-carrier Compensation Docket, December 22, 2008, p. 15.

1 the maximum disruption to Arizona end-users and the LECs serving them by
2 proposing immediate changes, a flash-cut, of intrastate access rates to the target
3 established by the Commission. Arizona Local Exchange Carriers Association
4 ("ALECA"), Verizon and Qwest propose a carrier specific transition, but a time
5 frame that is still fairly disruptive, which is no longer than three years. The Joint
6 CLECs propose a more gradual and predictable approach that extends over a
7 number of years. An extended transition period is necessary to minimize impacts
8 on both carriers and their end-user customers and allow carriers the time to alter
9 business plans. The task of altering business plans would be more difficult for
10 CLECs than many rural ILECs: CLECs, by definition, operate in retail markets
11 that are competitive. As a result, CLECs have limited ability to individually
12 increase rates to their end users – in other words they are essentially price-takers
13 in the market. In addition, many CLECs have term agreements with virtually all
14 of their end-user customers that limit the CLECs ability to make rate changes, to
15 the extent they actually had the ability to change these rates. Finally, CLECs may
16 also have term commitment contracts with their wholesale long distance providers
17 (service that CLECs package with their own local service and resell to end users).
18 To accommodate the specifics of CLECs business, CLECs propose that if they are
19 mandated to reduce access rates, the Commission implement the first phase of
20 mandated changes *no earlier than* three years after a decision is made in this
21 docket and then phase in additional changes over a number of years. This will
22 provide the CLECs the ability to fully adjust business plans and contracts and

1 attempt to mitigate the damage that will be done by reducing CLEC revenue from
2 switched access charges.

3 Fourth, as part of the transition procedure, the Commission needs to determine
4 whether it will provide carriers with an *alternate revenue source* to offset changes
5 in intrastate switched access. ALECA, AT&T, Verizon and Qwest all propose
6 that reductions in intrastate switched access revenues be recovered from increases
7 to end-user rates and the Arizona Universal Service Fund ("AUSF").⁹ These
8 proposals are focused on revenue recovery for rural ILECs. As mentioned
9 previously, CLECs have limited ability to increase rates, unless rate increases are
10 mandated for all CLEC competitors (including the ILECs) – a mandate which
11 would be questionable in a competitive market. Further, CLECs will be unlikely
12 to draw from an access revenue recovery fund, such as a USF, based on
13 limitations typically put in place before a carrier is allowed access to the fund.
14 Finally, it does not make economic or public policy sense to move a revenue
15 source that can be competed away into a revenue recovery mechanism that will
16 likely never be reduced.

17 Fifth, if a state universal service fund is going to be used to fund changes in
18 switched access revenues for at least some carriers, the Commission must decide
19 the *source of the money* for the fund. Most carriers propose that funding for the

⁹ Qwest proposes before a carrier is eligible to draw money from the AUSF it should "first be required to make a showing, either through a R14-2-103 filing, or through a simplified earnings review, that their earnings do not exceed the authorized rate of return." *Qwest Corporation's Reply Regarding Matrix Issues and Procedural Recommendations*, October 7, 2008, p. 2. The Joint CLECs support this proposal.

1 AUSF be based on intrastate revenues. Qwest clarifies that funding “should come
2 from all sectors of the industry, i.e. ILEC, CLEC, Cable, Wireless and VOIP
3 providers...”¹⁰ It should be noted that IXCs pay intrastate switched access today
4 in order to originate and terminate calls made by IXC customers. Creating a fund
5 based on all carriers’ intrastate revenues has the effect of requiring all carriers in
6 the state to subsidize IXCs’ customers. In other words, where previously IXCs
7 such as AT&T and Verizon paid rural carriers when AT&T and Verizon’s
8 Arizona customers made calls to rural areas, they now propose that CLECs’
9 Arizona end users contribute a share to a fund for the benefit of AT&T’s and
10 Verizon’s Arizona customers to originate and terminate long distance calls in
11 rural areas. The Joint CLECs find this problematic unless there is a clear showing
12 that the AUSF is for the purpose of *universal service* (rather than a pure benefit of
13 IXCs), and carriers drawing from the fund have demonstrated need as proposed
14 by Qwest. AT&T and Verizon propose mirroring whatever mechanism is used by
15 the FCC to fund the federal USF. This is not surprising since AT&T’s and
16 Verizon’s federal advocacy is to move USF contributions to a numbers based

¹⁰ *Qwest Corporation’s Reply Regarding Matrix Issues and Procedural Recommendations*,
October 7, 2008, p. 4.

1 system.¹¹ Because IXC operations in a state tend to eclipse the IXC's CLEC
2 operations, the proposal to shift to a numbers based contribution mechanism for
3 USF would provide additional cost savings for IXCs at the further expense of
4 Arizona end user customers.

5 Finally, if this proceeding is to address CLECs' access rates, then the Joint
6 CLECs recommend the Commission also establish *default rates to be paid to*
7 *LECs by wireless carriers for termination* of intrastate, intraMTA¹² calls. The
8 FCC recently clarified that states should establish these rates. Because AT&T has
9 expressed concern about different terminating rates, "distorting competition in the
10 telecommunications marketplace,"¹³ the Joint CLECs recommend the
11 Commission establish the wireless intrastate, intraMTA rate terminating to
12 CLECs identical to the rate established for terminating intrastate switched access
13 (just as interstate, interMTA rates are identical to CLECs interstate switched
14 access rates).

15 **Q. WHAT ARE THE JOINT CLEC PROPOSALS TO THIS COMMISSION?**

¹¹ A numbers based contribution mechanism would fund the AUSF based on assigned telephone numbers in the state of Arizona. A revenue based contribution mechanism would fund the AUSF based on intrastate revenues. The difference of the two proposals will be based on the relative number of assigned telephone numbers compared with the relative amount of intrastate revenues for each carrier. An advantage of the numbers based contribution mechanism is that it is easier to collect funding from VOIP and wireless providers whose revenue may be difficult to jurisdictionally classify. A disadvantage of a numbers based system is that providers of telecommunications services that have few, or no, assigned numbers (e.g. long-distance service) would not contribute to the fund.

¹² IntraMTA calls are calls within a single Major Trading Area ("MTA") – an area that defines "local calling" market of wireless carriers.

¹³ *AT&T's Issues Matrix and Procedural Recommendations*, October 7, 2008, p. 2.

1 A. The Joint CLEC recommendations are summarized below:

2 (1) The Commission should first address rural ILEC access rates before
3 addressing CLEC access rates.

4 (2) Any target access rate other than cost is arbitrary. To the extent the
5 Commission elects to implement an arbitrary benchmark for CLECs, then Joint
6 CLECs recommend the 1999 Qwest access rates be used.

7 (3) A transition period should include ample time for a carrier to adjust its
8 business plans. If CLEC access rates are to be reduced, then the Joint CLECs
9 recommend a 3 year period before reductions are implemented so that the CLECs
10 can adjust their business plans and term contracts appropriately. After the three
11 year period, the Joint CLECs recommend rate reductions be phased in gradually
12 over a five to seven year period.

13 (4) While the Joint CLECs support the concept of universal service, the Joint
14 CLECs are concerned about creation of an access revenue recovery fund. If the
15 AUSF is to be expanded, then the Joint CLECs support the recommendations
16 outlined by Qwest, which provide that funds should only be distributed based
17 upon a demonstration of need and that contributions should come from every
18 provider of telecommunications services.

19 (5) To the extent CLEC access rates are to be addressed in this proceeding, the
20 Joint CLECs recommend that the Commission also establish the rate for

1 intraLATA, intraMTA calls terminated by wireless providers to LECs. The rate
2 established by the Commission should equal the intrastate access rate the
3 Commission applies to each CLEC.

4
5 **II. ISSUES POSED BY THE PROCEDURAL ORDER**

6
7 **Issue 1. What carriers should be covered by access reform?**

8
9 **This Proceeding Should First Focus on Rural LEC Access Rates**

10
11 **Q. AMONG THE MULTIPLE PARTY COMMENTS, IS THERE ONE AREA**
12 **OF CLEAR AGREEMENT?**

13 A. Yes. All carriers agree, or at least do not oppose, the Commission reviewing and
14 undertaking access reform for the rural ILECs in Arizona. For the purposes of
15 this proceeding carriers in Arizona can be grouped into three groups, non-rural
16 ILECs (i.e. Qwest), rural ILECs, and CLECs. Both AT&T and Verizon propose
17 that all carriers be subject to this proceeding.¹⁴ Qwest and Staff argue that
18 Qwest's access rates should be excluded from this proceeding.¹⁵ ALECA argues
19 that the docket should focus on "preserving and promoting the widespread

¹⁴ See *AT&T's Issues Matrix and Procedural Recommendations*, October 7, 2008, p. 3 and *Verizon's List of Issues*, October 7, 2008, p. 2.

¹⁵ See *Qwest Corporation's Reply Regarding Matrix Issues and Procedural Recommendations*, October 7, 2008, p. 1 and *Staff Response*, April 8, 2009.

1 availability and affordability of basic local exchange service in rural Arizona.”¹⁶

2 ALECA adds that it does not oppose the inclusion of CLEC access charges,
3 “provided doing so does not distract from the primary focus.”¹⁷ The Joint CLECs
4 generally argue that while an investigation of switched access rates in Arizona is
5 premature given discussions that are underway at the FCC, if the Commission is
6 to proceed, it should focus first are rural ILECs.¹⁸

7 Given that the Commission is proceeding with this docket, it is clear that one area
8 of agreement among all the parties is that rural ILEC access rates should be
9 reviewed.

10
11 **The Commission Should Wait Until the FCC Acts on Intercarrier Compensation**

12
13 **Q. DOES THE FCC REALLY PLAN TO ADDRESS INTERCARRIER**
14 **COMPENSATION?**

15 A. Yes. Just recently the FCC issued a public notice regarding intercarrier
16 compensation and the National Broadband Plan.¹⁹ The FCC requested
17 information regarding “how the current intercarrier compensation system either

¹⁶ *Issues Matrix Arizona Local Exchange Carriers Association*, October 7, 2008, p. 1.

¹⁷ *Issues Matrix Arizona Local Exchange Carriers Association*, October 7, 2008, p. 1.

¹⁸ See *Integra Telecom’s Statement of Issues*, October 7, 2008, p. 2; *McLeodUSA’s Statement on Issues*, October 7, 2008, p. 2; and *Procedural Recommendations*, filed on behalf of tw telecom and XO, October 7, 2008, pp. 2-3.

¹⁹ *Comment Sought on the Role of the Universal Service Fund and Intercarrier Compensation in the National Broadband Plan*, GN Docket Nos. 09-47, 09-51, 09-137, DA 09-2419, Released November 13, 2009.

1 supports or inhibits broadband deployment, *rather than conclusory assertions*
2 *that intercarrier compensation should be reformed.*²⁰ Among the information
3 sought by the FCC were minutes and payments for intercarrier compensation over
4 the past three to five years, intercarrier compensation as a percent of total
5 expenses, intercarrier compensation subject to jurisdictional dispute, costs that
6 could be avoided if jurisdictional disputes were eliminated, total minutes of transit
7 traffic, and the impact of intercarrier compensation reform on transit voice and
8 data rates.²¹ Initial comments are due on December 7, 2009.²²

9 **Q. WHY IS FEDERAL INTERCARRIER COMPENSATION REFORM**
10 **TAKING SO LONG?**

11 A. I suspect that a resolution on intercarrier compensation is taking so long precisely
12 because these are complicated issues, involving a multitude of different carriers,
13 each with its own customer and business interest. The attempt to find a unified
14 solution to all intercarrier compensation issues has likely slowed down the pace of
15 reform. Both the FCC and the Arizona Commission may be best served by
16 dealing first with areas of consensus, such as rural ILEC access rates, rather than
17 attempting to fit the multitude of LECs through the proverbial square hole.

²⁰ *Id.*, p. 5 (emphasis added).

²¹ *Id.*, p. 5.

²² *Id.*, p. 1.

1 **Q. IS AT&T'S POSITION THAT THE STATE NEEDS TO ACT QUICKLY**
2 **TO UNDERTAKE INTRASTATE ACCESS REFORM CONSISTENT**
3 **WITH ITS ADVOCACY BEFORE THE FCC?**

4 A. No. While AT&T calls on the Arizona Commission to take urgent action on
5 intrastate switched access rates,²³ AT&T is asking the FCC to take jurisdiction
6 over the intrastate switched access and reciprocal compensation rates away from
7 the states. AT&T argues, "It would have been especially perverse for Congress to
8 have authorized the [FCC] to reform intercarrier compensation rules related to
9 'local' and 'interstate' traffic but not the rules applicable to the one class of traffic
10 – intrastate access – that is subject to the highest above-cost charges... If the
11 Commission lacked authority to establish a national solution for this national
12 problem, the problem would never get fixed."²⁴ In other words, while AT&T and
13 Verizon²⁵ ask this Commission and carriers in Arizona to invest the time and
14 resources in addressing intrastate switched access rates, it asks the FCC to take
15 jurisdiction over intrastate switched access rates away from this Commission.
16 While the Joint CLECs believe that this Commission does have jurisdiction over
17 intrastate switched access rates,²⁶ carriers such as AT&T should not be able to
18 force unwilling carriers to participate in resource intensive and potentially

²³ See *AT&T's Issues Matrix and Procedural Recommendations*, October 7, 2008, p. 2.

²⁴ *Reply Comments of AT&T Inc.*, FCC Intercarrier Compensation Docket, December 22, 2008, pp. 8 and 9.

²⁵ Verizon has also requested that the FCC take jurisdiction of intrastate switched access from state commissions. FCC Intercarrier Compensation Docket, November 26, 2008, p. 9.

²⁶ This position is consistent with the concerns expressed by this Commission. See *Reply Comments of the Arizona Corporation Commission*, FCC Intercarrier Compensation Docket, December 22, 2008, p. 2.

1 meaningless proceedings, while AT&T argues for the FCC to remove jurisdiction
2 from the states.

3 **Access Rates of Joint CLECs are Reasonable**
4

5 **Q. BESIDES PENDING FCC ACTION, WHY DO THE JOINT CLECS**
6 **ARGUE THAT THE COMMISSION NEED NOT TAKE ACTION WITH**
7 **RESPECT TO CLEC ACCESS AT THIS TIME?**

8 A. There has been no evidence presented that CLEC access rates are in need of
9 review or change. The simple fact that AT&T and Verizon desire increased
10 profitability at the expense of CLECs is not justification for a change in CLEC
11 access rates. No party has demonstrated that CLEC rates are unjust or
12 unreasonable. In fact, one probable reason AT&T and Verizon do not make this
13 claim is that their intrastate switched access rates are virtually identical to CLEC
14 rates. The table below compares the intrastate switched access rates for AT&T
15 and Verizon with the rates for the Joint CLECs.²⁷

²⁷ These rates exclude tandem switching, but include 10 miles of tandem transport, as well as local switching and other per minute charges.

Table 1: Originating and Terminating Access Rate Comparison

LEC	Originating	Terminating	Source Intrastate Tariff
AT&T LEC	\$ 0.02803	\$ 0.04223	AT&T Communications of the Mountain States Access Services and Network Interconnection Services Price List
Verizon LEC	\$ 0.05027	\$ 0.07115	MCImetro Access Transmission, Tariff No. 2
Average AT&T and VZ	\$ 0.03915	\$ 0.05669	
Integra:			
ELI	\$ 0.02990	\$ 0.04270	Switched Exchange Access Telecom Services Tariff No. 3
Eschelon	\$ 0.02967	\$ 0.05241	Access Service Tariff No. 2
Mountain	\$ 0.02967	\$ 0.05241	Telecommunications Tariff No. 1
McLeodUSA	\$ 0.05523	\$ 0.05523	Intrastate Access Tariff No. 4
tw telecom	\$ 0.03610	\$ 0.04409	Intrastate Telecommunications Access Services Tariff No. 4
XO	\$ 0.03434	\$ 0.04854	Access Service Tariff No. 7
Average JCLECs	\$ 0.03582	\$ 0.04923	
Qwest Pre-Price Cap	\$ 0.02803	\$ 0.04223	See note below

Current tariffs can be found on the ACC web site: <http://www.azcc.gov/Divisions/Utilities/Tariff/util-tariffs-telecom.asp>. Qwest's historical access rates are based on Docket No. T-01051B-99-0105 (1999 Price Cap Docket), Testimony of Barbara M. Wilcox on behalf of Qwest, January 8, 1999, Exhibit BMG-5.

As shown in Table 1 above, "JCLECs" (i.e. Joint CLECs) current rates are similar to access rates of AT&T and Verizon in Arizona. The most likely reason that these rates are similar across the various carriers is that these rates were originally set to be similar to the intrastate switched access rates of the incumbent LEC,

1 Qwest, prior to the two most recent price cap cases. The time period preceding
2 Qwest's price cap cases corresponds with the time when CLECs were establishing
3 business plans and entering the local telecommunications market.

4 As shown in table 1, Qwest's intrastate switched access rates in 1999, prior to the
5 first price cap reductions, were \$0.02803 per originating minute and \$0.04223 per
6 terminating minute.²⁸ With the inclusion of tandem switching, Qwest rates were
7 \$0.03478 per originating minute and \$0.04898 per terminating minute.

8 **Q. WHY DIDN'T CLECS REDUCE THEIR ACCESS RATES WHEN QWEST**
9 **REDUCED ITS ACCESS RATES AS A RESULT OF ITS PRICE CAP**
10 **DOCKETS?**

11 A. There was no reason, or benefit, for CLECs to reduce access rates as a result of
12 Qwest's price cap dockets. During the 1999 Price Cap Docket Qwest and staff
13 entered into a settlement agreement, which was approved by the Commission with
14 modifications.²⁹ As part of this settlement agreement Qwest agreed to intrastate
15 switched access rate reductions of \$15 million spread over a three year period.
16 Qwest was able to make revenue neutral rate increases to offset these

²⁸ These rates were calculated in the same manner as the rates in table 1. The individual rate components were taken from the Testimony of Barbara M. Wilcox, Exhibit BMW-5, In the Matter of the Application of U S WEST Communications, Inc. for a Hearing to Determine the Earnings of the Company for Ratemaking Purposes, to fix a Just and Reasonable Rate of Return thereon and to Approve Rate Schedules, Docket No. T-01051B-99-0105 ("1999 Price Cap Docket"), January 8, 1999, Exhibit BMG-5. According to AT&T and Qwest witnesses, Qwest average intrastate switched access rate in Arizona was \$.0045 per minute. See *Testimony of Arleen M. Starr on Behalf of AT&T*, 1999 Price Cap Docket, November 13, 2000, p. 2, citing to Testimony of Barbara M. Wilcox on behalf of Qwest.

²⁹ *Opinion and Order*, 1999 Price Cap Docket, Decision No. 63487, March 30, 2001, p. 26.

1 reductions.³⁰ CLEC access rates were not part of this agreement. Nowhere in
2 Qwest's 1999 Price Cap docket were CLEC access rates discussed and there was
3 no notice to CLECs that their rates might be subject to reductions as a result of a
4 settlement agreement entered into by Qwest, for its own benefit.

5 Likewise, during the 2003 Price Cap Docket,³¹ Qwest entered into a settlement
6 agreement with staff, DOD, MCI, TWTA, AUIA, XO and Cox.³² This agreement
7 called for \$12 million in intrastate switched access rate reductions and allowed
8 Qwest to make revenue neutral rate increases.³³ While some CLECs were a party
9 to this agreement, there is no discussion in the docket that these intrastate
10 switched access rate reductions would be applied to CLECs and there was no
11 general notice to CLECs that their rates might be reduced as a result of the 2003
12 Price Cap Docket.

13 It would be inappropriate to apply the results of these dockets, or expect CLECs
14 to follow settled results of these dockets when the CLECs were not noticed that
15 the rate changes could extend to them and thus, could not effectively participate
16 and represent their interest in the docket and subsequent settlement discussions.

³⁰ *Opinion and Order*, 1999 Price Cap Docket, Decision No. 63487, March 30, 2001, Exhibit A Settlement Agreement, p. 3.

³¹ In the Matter of Qwest Corporation's Filing of Renewed Price Regulation Plan, Docket No. T-01051B-03-0454 ("2003 Price Cap Docket").

³² *Opinion and Order*, 2003 Price Cap Docket, Decision No. 68604, August 23, 2005, p. 5.

³³ *Opinion and Order*, 2003 Price Cap Docket, Decision No. 68604, August 23, 2005, p. 7.

**The Commission Should Also Establish the Terminating Rate for Intrastate,
IntraMTA Wireless Calls**

**Q. IF THE COMMISSION IS GOING TO EXPAND THE SCOPE OF THIS
PROCEEDING BEYOND INTRASTATE SWITCHED ACCESS RATES
FOR RURAL CARRIERS, WHAT OTHER INTERCARRIER
COMPENSATION ISSUES SHOULD THE COMMISSION CONSIDER?**

A. If the Commission expands the scope of this docket, it should also establish the
rates that wireless carriers pay to LECs to terminate intrastate, intraMTA traffic.

The FCC recently clarified that states should establish these rates following a
complaint of a California CLEC, North County Communications Corp. ("North
County") against a wireless carrier for failing to pay for terminating traffic
originated on the wireless carrier's network and failing to negotiate in good faith
an interconnection agreement for the exchange of traffic. The complaint, in part,
"asked the Commission to issue an order (i) prescribing a rate (under section 205
of the Act) for terminating intrastate traffic between the parties at or above the
rate billed by North County..."³⁴ The FCC determined, "the California PUC is
the more appropriate forum for determining the reasonable compensation rate for
North County's termination of intrastate, intraMTA traffic..."³⁵

³⁴ *Order on Review*, North County Communications Corp., Complainant, v. MetroPCS California, LLC, Defendant., File No. EB-06-MD-007, Released November 19, 2009 ("North County Order on Review"), ¶ 9.

³⁵ North County Order on Review, ¶ 12.

1 As a result, if the Arizona Commission is going to review the CLEC rates for
2 intrastate switched access, it should also establish a default rate for wireless
3 carriers to terminate intrastate, intraMTA traffic to the CLEC. Since carriers such
4 as AT&T have expressed concern about different terminating rates, "distorting
5 competition in the telecommunications marketplace,"³⁶ the Joint CLECs
6 recommend the Commission establish the wireless intrastate, intraMTA
7 terminating rate identical to the rate established for CLECs for terminating
8 intrastate switched access. This solution would be consistent with the process
9 used today to set the rates for wireless termination of interMTA traffic, for which
10 wireless carriers pay interstate switched access rates.

11
12 **Issue 2. To what target level should access rates be reduced?**

13
14 **Any Target Other Than The Carrier Cost is Arbitrary**

15 **Q. SHOULD CLEC ACCESS RATES BE REDUCED?**

16 A. No. As noted previously, there is no need for reform of CLEC access charges at
17 this time. Intrastate access charges are a diminishing source of revenue due to
18 technological changes and the use of unregulated alternatives for long distance
19 calling. Furthermore, the FCC is proceeding with comprehensive access charge
20 reform that may render any state commission action moot. Finally, the issues
21 faced by CLECs are much different than those faced by rural ILECs.

³⁶ *AT&T's Issues Matrix and Procedural Recommendations*, October 7, 2008, p. 2.

1 **Q. IF THE COMMISSION DECIDES TO EVALUATE CLEC ACCESS**
2 **RATES, WHAT TARGET SHOULD THE COMMISSION USE IN THIS**
3 **EVALUATION?**

4 A. First, there has been no evidence presented in this proceeding that CLEC access
5 rates are excessive or are not just and reasonable. IXC demands to pay less is not
6 evidence that rates need to be reviewed or regulated. If it is determined that
7 CLEC intrastate switched access rates should be review, then most proper basis
8 for review is each CLEC's cost. This Commission stated, "The Arizona
9 Commission does not support the adoption of a one-size-fits-all approach with
10 respect to the establishment of reciprocal compensation rates. The rates
11 established by the state commission should reflect the costs of providing the
12 service for the particular carriers involved."³⁷ If a carrier has developed a
13 switched access cost study, the Commission should evaluate the carrier's
14 switched access rates in relation to its switched access costs. If and only if the
15 margin (or the difference between cost and rate) of these access rates is much
16 greater than the margins provided by other telecommunications companies,
17 particularly those contained in the underlying wholesale rates (such as special
18 access) of incumbent providers, should the Commission consider mandated
19 changes to a CLEC's intrastate switched access rates. If the carrier has not
20 developed a switched access cost study, the Commission could evaluate the
21 CLEC's rates in comparison to *similarly-situated* carriers. (As explained below,

³⁷ Reply Comments of the Arizona Corporation Commission, FCC Inter-carrier Compensation Docket, December 22, 2008, p. 15.

1 Qwest and other Regional Bell Operating Carriers ("RBOCs") are not similarly-
2 situated to any CLEC.) If and only if CLEC's intrastate switched access rates are
3 outside a zone of reasonableness defined by the switched access rates of similarly-
4 situated carriers (and the CLEC does not have a cost study to justify its rates)
5 should the Commission consider whether the CLEC's intrastate switched access
6 rates should be regulated. In any case, if the carrier develops a cost study at a
7 later date, the CLEC (or any other LEC) should have the right to justify its access
8 rates via a switched access cost study.

9
10 **Qwest's Intrastate Switched Access Rates Are Not An Appropriate Target**

11
12 **Q. PLEASE EXPLAIN WHY QWEST'S INTRASTATE SWITCHED ACCESS**
13 **RATES ARE NOT AN APPROPRIATE TARGET WHEN EVALUATING**
14 **CLECS ACCESS RATES.**

15 A. Qwest's intrastate switched access rates are not an appropriate target or
16 benchmark when evaluating CLEC access rates for two reasons. First, as
17 explained above in relation to Issue 1, Qwest's current intrastate switched access
18 rates were set as a result of negotiations that Qwest agreed to for its own benefit.
19 Qwest reductions in intrastate switched access rates from 2001 forward were
20 made in conjunction with revenue neutral price increases in other rates. The rate
21 reductions voluntarily agreed to by Qwest were implemented in conjunction with
22 Qwest's Price Cap Plan and were correctly not considered appropriate for CLECs.

1 Second, to the extent Qwest's intrastate switched access rates bear any residual
2 relation to its cost or other financial considerations, these costs or other financial
3 considerations have no relation to CLECs' cost or their other financial
4 considerations.

5 **Q. PLEASE EXPLAIN WHY QWEST'S SWITCHED ACCESS COST HAVE**
6 **NO RELATION TO CLEC'S COST.**

7 A. CLECs and large ILECs like Qwest have very little in common in terms of their
8 underlying costs and network architectures. First, as new entrants that hold
9 smaller market share than the incumbents, CLECs have a sparser customer base
10 (lower customer density) than large ILECs. As a result, CLECs lag behind ILECs
11 in scale economies because they lack the size necessary to produce average, per-
12 unit costs as low as those enjoyed by large ILECs.

13 Second, because of their smaller size, CLECs face higher input prices and often a
14 higher cost of capital than large ILECs, who enjoy greater access to capital and
15 the ability to purchase equipment in larger quantities at significant discounts. In
16 addition, because constructing telecommunications facilities is often cost-
17 prohibitive, CLECs lease portions of the ILEC local facilities such as local loop,
18 interoffice transport and collocation space in ILEC central offices. While five
19 years ago, for example, CLECs were able to purchase all of these facilities as
20 unbundled network elements ("UNE") at cost-based prices, prices paid by CLECs
21 for these facilities have increased. These increases result largely from the fact

1 that the FCC's Triennial Review Order and Triennial Review Remand Order³⁸
2 removed the ILEC's obligation to provide unbundled high-capacity loops and
3 transport at UNE (cost-based) prices in certain wire centers, and in some cases
4 capped the quantity of high-capacity facilities CLECs can buy in all other wire
5 centers. Today, in order to lease high-capacity loop and transport facilities in
6 these situations, CLECs have to pay significantly higher, *above cost* rates based
7 on special access tariffs or commercial agreements. In other words, CLECs buy
8 inputs to their switched access service at prices that are significantly higher than
9 input prices faced by Qwest (which are Qwest's own cost of provisioning these
10 inputs/facilities to itself – cost captured by UNE rates).

11 Third, CLECs tend to have lower facility utilization than large ILECs: While an
12 ILEC's predecessors built the ILEC customer base in protected markets over the
13 course of more than one hundred years, CLECs must deploy some number of
14 these facilities (such as switches) at once before they even begin to attract
15 customers. Because the per unit cost of installing larger facility (such as a large
16 switch) at once is lower than the cost of installing a smaller switch initially and
17 augmenting its capacity as demand grows, it is more economical to install a large

³⁸ *In the Matter of Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers, Implementation of the Local Competition Provisions of the Telecommunications Act of 1996, Deployment of Wireline Services Offering Advanced Telecommunications Capability*, CC Docket No. 01-338/96-98/98-147, Report and Order and Order on Remand and Further Notice of Proposed Rulemaking, FCC 03-36, Rel. August 21, 2003 ("Triennial Review Order" or "TRO"). *In the Matter of Unbundled Access to Network Elements, Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers*, WC Docket No. 04-313, CC Docket No. 01-338, FCC 04-290, rel. February 4, 2005 ("Triennial Review Remand Order" or "TRRO").

1 capacity during the initial deployment. This means that, over much of their
2 economic life, the utilization of CLEC facilities is likely to be substantially below
3 full capacity. Either way, CLECs are faced with either lower utilization or higher
4 per unit costs as they grow their networks and attract customers. In contrast,
5 when an ILEC installs a new digital switch or replaces a transport route with more
6 efficient technology, it normally does so to replace existing facilities that are
7 already highly utilized. This means that, typically, from the moment the ILEC
8 installs a new facility, it will be highly utilized. In other words, ILECs have
9 higher capacity utilization of their switched access facilities due to their dominant
10 incumbent position as keeper of the public switched telephone network.

11 Next, the typical CLEC network design is materially different than Qwest's
12 network design (or network of any other large ILEC) because the economics of
13 deploying a competitive network is substantially different than the economics of
14 deploying a network designed to serve a much denser ILEC customer base: For
15 example, Qwest's network is hierarchical and consists of multiple wire centers
16 (local switches) placed to aggregate traffic of a relatively dense customer base and
17 transport to a hierarchical tandem office. CLEC's network consists of fewer
18 switches and substantially increased levels of transport and traffic aggregation
19 facilities. This network architecture is sometimes referred to as "distributed"
20 architecture, as opposed to the ILECs "hierarchical" architecture. To provide a
21 more specific example, a CLEC would typically deploy one switch to serve a
22 large market, such as Phoenix Metropolitan Statistical Area ("MSA") (a switch

1 that combines functionalities of a local and tandem switch), while Qwest has over
2 60 switches in this MSA.

3 Last, CLECs experience an additional cost component in offering switched access
4 services that is not experienced by the ILECs: collocation. Most CLECs connect
5 to their end users through ILEC owned collocation facilities. Thus, even if
6 CLECs and ILECs were to have identical costs for all other service components –
7 and they don't – CLECs would incur higher costs because their switched access
8 services involve collocation. In other words, even if a CLEC were to be as
9 efficient as the ILEC in the provision of switched access, its costs would still be
10 higher.

11 **Q. WHAT ARE THE COST IMPLICATIONS TO CLECS' DIFFERENT,**
12 **DISTRIBUTED NETWORK ARCHITECTURE?**

13 A. The advantage of this architecture is that it minimizes the amount of switching
14 and central office investment required to serve a more dispersed customer base,
15 both by minimizing the number of local switches, and eliminating the need for a
16 stand-alone tandem switch. The tradeoff is that this network architecture requires
17 substantial additional investment in transport and collocation facilities necessary
18 to aggregate traffic and deliver it to the centralized switch. Because transport and
19 aggregation equipment must be sized in relation to the amount of traffic it
20 supports, most of the costs of these additional network components relied upon by
21 CLECs are *traffic sensitive* in nature, thereby generating *traffic sensitive costs*.

1 Recall that usage-based switched access rates are, in general, intended to recover
2 the traffic sensitive costs LEC incurs in accommodating the long distance traffic
3 of IXC. Because CLEC networks tend to deploy more traffic sensitive
4 investment as compared to ILEC networks (which rely more heavily on
5 ubiquitous loop facilities to aggregate traffic to multiple, local switches), it
6 follows that CLECs have more traffic sensitive costs to recover via their switched
7 access rates compared to ILECs.

8
9 **RBOCs Interstate Switched Access Rates Are Not An Appropriate Target**

10
11 **Q. WHY IS IT INAPPROPRIATE TO USE QWEST (OR OTHER RBOCs)**
12 **INTERSTATE SWITCHED ACCESS RATES AS A TARGET OR**
13 **BENCHMARK FOR CLEC INTRASTATE SWITCHED ACCESS RATES?**

14 **A.** It is inappropriate to use RBOCs interstate rates for the same reasons that it is
15 inappropriate to use Qwest's intrastate switched access rates as a target – these
16 rates were set as a result of negotiations between RBOCs and IXCs (negotiations
17 in which, as explained below, neither CLECs, nor this Commission were a party
18 or beneficiary of), and that to the extent these rates contain any residual
19 relationship to the RBOCs cost or other financial considerations, these costs and
20 financial considerations have no relation to CLECs' costs and CLECs' financial
21 considerations.

1 **Q. IS THE FCC'S *CALLS ORDER* – A LANDMARK ORDER PERTAINING**
2 **TO RBOCS INTERSTATE ACCESS RATES – A GOOD EXAMPLE OF**
3 **WHY ILEC RATES ARE SO INAPPROPRIATE FOR CLECS?**

4 A. Yes. In this Order (dated May 31, 2000), the FCC adopted an “integrated
5 interstate access reform and universal service proposal” put forward by AT&T,
6 Bell Atlantic, GTE, SBC and Sprint (referred to by the FCC as the Coalition for
7 Affordable Local and Long Distance Service – *CALLS*).³⁹ The *CALLS Order*
8 substantially altered interstate switched access rates for all price cap carriers
9 (including Qwest). The primary focus was to reduce interstate access rates paid
10 by IXC's, while at the same time allowing price cap LECs (including Qwest) to
11 recover those same monies through the interstate universal service support
12 mechanism (*i.e.*, largely a revenue neutral undertaking for the ILECs).⁴⁰

13 **Q. HOW WERE THE ILEC INTERSTATE ACCESS RATES SET IN THE**
14 ***CALLS ORDER*?**

15 A. The access rates produced by the *CALLS Order* were set through a *negotiated*
16 agreement reached by the ILECs and IXC's. These behind the scenes negotiations
17 are revealed in a dissent by then FCC Commissioner Harold Furchtgott-Roth.⁴¹
18 In his dissent, Commissioner Furchtgott-Roth expressed his opinion that “the

³⁹ *Access Charge Reform, Price Cap Performance Review for Local Exchange Carriers*, CC Docket Nos. 96-262 and 94-1, Sixth Report and Order, *Low-Volume Long Distance Users*, CC Docket No. 99-249, Report and Order, *Federal-State Joint Boards on Universal Service*, CC Docket No. 96-45, Eleventh Report and Order, 15 FCC Rcd 12962 (2000) (hereafter “*CALLS Order*”).

⁴⁰ *CALLS Order*, ¶¶29-35, especially, ¶¶30 and 32.

⁴¹ *Statement of Commissioner Harold Furchtgott-Roth, Concurring in Part and Dissenting in Part*, appended to the *CALLS Order*, May 21, 2000 (“*Furchtgott-Roth Dissent*”).

1 process by which the original CALLS proposal was modified [and ultimately
2 approved] is fundamentally inconsistent with principles of neutrality and
3 transparency that must govern agency decision making.”⁴² Specifically, the
4 Furchtgott-Roth Dissent reveals two important aspects of this process:

5 [A] number of parties with interests in the outcome of this proceeding,
6 including the Ad Hoc Telecommunications Users Committee, Time
7 Warner Telecom, and the Association for Local Telecommunications
8 Services, were not allowed to participate.⁴³

9 [P]roceedings that were unrelated to the issue of access charge reform
10 became part of the negotiations. Incumbent local exchange carrier
11 members of the Coalition apparently contended that they could not
12 commit to certain modifications of the CALLS proposal unless they had
13 confidence that two separate matters – a depreciation waiver item and the
14 pending special access proceeding, which concerns the circumstances in
15 which carriers may purchase combinations of unbundled loops and
16 transport network elements – would be resolved favorably to them. As a
17 consequence, part of the final agreement reached by the participants to the
18 CALLS negotiations concerned these two separate matters. With respect
19 to this depreciation item, the Bureau agreed to recommend to the
20 Commission that it approve the waiver that is the subject of this Notice
21 and terminate the CPR audits. Additionally, the Bureau agreed to
22 recommend to the Commission that it “clarify” the existing rules regarding
23 special access and defer further rulemaking until 2001.⁴⁴

24 **Q. DOES THE ABOVE DISCUSSION SHOW THAT THERE IS NO SOLID**
25 **COST FOUNDATION FOR THE ILEC INTERSTATE ACCESS RATES**
26 **THAT CAME OUT OF THE CALLS ORDER?**

27 **A. Yes. The RBOCs’ access rates resulting from the CALLS Order were established**
28 **through a “closed door” negotiated settlement between parties allowed the benefit**

⁴² *Statement of Commissioner Harold Furchtgott-Roth, Concurring in Part and Dissenting in Part, appended to the CALLS Order, May 21, 2000 (“Furchtgott-Roth Dissent”).*

⁴³ *Furchtgott-Roth Dissent.*

⁴⁴ *Furchtgott-Roth Dissent (footnotes omitted).*

1 of participating, each with its own agenda and objectives, some of which had
2 nothing to do with switched access. The Commission should not compound the
3 problem for CLECs by adopting as a CLEC intrastate benchmark a rate level that
4 was established without any CLEC input, particularly given the arbitrary manner
5 in which these levels were established.

6
7 **Benchmarked Rates Will Possibly Be Confiscatory**

8
9 **Q. DO PROPOSALS TO CAP CLEC ACCESS RATES RUN INTO DANGER**
10 **OF BEING CONFISCATORY AND HARMFUL LOCAL COMPETITION?**

11 A. Yes. For almost a century it has been a standard principle in public utility
12 regulation that rates – when regulated – be set at levels that allow a company a
13 reasonable opportunity to recover the costs of providing the regulated service,
14 otherwise they are confiscatory.⁴⁵ In New Jersey, in a switched access proceeding
15 much like this one, Verizon witnesses forewarned the New Jersey Board to not set
16 rates at confiscatory levels by referring to Brooks-Scanlon Co. v. Railroad
17 Comm’n, 251 U.S. 396 (1920), where the United States Supreme Court barred
18 exactly what some parties are seeking here – service at a price less than the cost to
19 provide that service.⁴⁶ Further demonstrating the inappropriateness of such

⁴⁵ In this section, I use “confiscatory” and “confiscation” not as a legal terms but as they are used in common speech.

⁴⁶ In the Matter of the Board’s Investigation and Review of Local Exchange Carrier Intrastate Exchange Access Rates, State of New Jersey Board of Public Utilities Docket No. TX08090830, Exhibit Verizon- 1P, Initial Testimony of Paul B. Vasington and Thomas J. Mazziotti, p. 45.

1 advocacy for benchmarks, Verizon proceeded to quote Justice Holmes stating that
2 a company cannot “be compelled to spend any other money to maintain [the
3 enterprise] for the benefit of others who do not care to pay for it.”⁴⁷

4 The FCC, in establishing the price cap regime for LECs, likewise recognized that
5 below-cost rates would be confiscatory:

6 [A] price cap LEC may petition the Commission to set its rates
7 above the levels permitted by the price cap indices based on a
8 showing that the authorized rate levels will produce earnings that
9 are *so low as to be confiscatory*.⁴⁸ (Emphasis added.)

10
11 The Commission should note that benchmark policies are deeply disruptive of the
12 CLECs’ ability to compete. While exchange access rates are generally
13 compensatory for ILECs, benchmarked rates typically are not for CLECs; as such,
14 they will leave a significant portion of the CLECs’ costs to go unrecovered. This
15 is unfair and, as noted, possibly confiscatory.

16 Further, benchmark policies will not serve ratepayers well. CLECs may be forced
17 to forfeit millions of dollars when IXC’s gain access to their networks at below
18 cost rates. The suggestion that CLECs can recoup those costs from end users,
19 offered by advocates of benchmark policies, is wrong: CLECs do not have a base
20 of monopoly rate payers on whom to foist cross-subsidies and competitive retail
21 markets do not permit arbitrary markups for unrecovered costs. While the IXCs

⁴⁷ *Id.*

⁴⁸ *CALLS Order*, ¶ 17.

1 will improve their bottom line, this permanent drain on CLEC resources will
2 invariably curtail the CLECs' ability to expand their networks and compete
3 vigorously, to the ultimate detriment of telecom markets and end user customers
4 in Arizona.

5
6 **The FCC Never Intended to Have States Follow Its Policies**

7
8 **Q. DOES THE FCC HAVE A BENCHMARK POLICY FOR CLEC**
9 **INTERSTATE ACCESS RATES?**

10 A. Yes. The FCC adopted a transitional benchmarking policy for CLEC access rates
11 in its 2001 *CLEC Access Charge Order*,⁴⁹ which capped the CLEC interstate
12 access rates to the rate of the ILEC with which the CLEC competes.⁵⁰

13 **Q. WHY IS IT INAPPROPRIATE TO APPLY THE FCC'S FINDINGS MADE**
14 **IN THE ORDER ISSUED IN 2001 TO THE SITUATION IN ARIZONA**
15 **TODAY?**

16 A. The findings in the FCC's 2001 Order were explicitly transitional and, since that
17 time, changes have taken place in the telecommunications marketplace that show
18 that the transitional mechanism adopted by the FCC for interstate access eight
19 years ago is not warranted in Arizona today.

⁴⁹ *In the Matter of Access Charge Reform*, Seventh Report and Order and Further Notice of Proposed Rulemaking, CC Docket No. 96-262; FCC 01-146, April 27, 2001 ("*CLEC Access Charge Order*").

⁵⁰ *CLEC Access Charge Order*, ¶52.

1 **Q. PLEASE ELABORATE ON YOUR STATEMENT THAT THE FCC'S**
2 **BENCHMARKING POLICY WAS EXPLICITLY TRANSITIONAL.**

3 A. The FCC specifically stated that its benchmark was *transitional*. The FCC said:

4 We stress, however, that the [benchmark] mechanism set out below is a
5 *transitional* one; it is not designed as a permanent solution to the issues
6 surrounding CLEC access charges. Rather, we view the mechanism we
7 adopt today as a means of moving the marketplace for access services
8 closer to a competitive model. Because our tariff benchmark is tied to the
9 incumbent LEC rate, we will re-examine these rates at the close of the
10 period specified in the *CALLS Order*. Through a separate notice of
11 proposed rulemaking that we issue today, we also evaluate the access
12 charge scheme as part of a broader review of inter-carrier compensation.⁵¹

13 As explained in ¶19 of the *CLEC Access Charge Order*, “[t]he *CALLS Order* is
14 interim in nature, covering a five-year period; its reforms became effective on
15 July 1, 2000.”⁵² Though the FCC is currently engaged in efforts to
16 comprehensively address inter-carrier compensation issues, the FCC has yet to
17 take action more than eight years later. As explained below, market
18 developments that have taken place since the FCC instituted its interstate
19 benchmark in 2001 no longer warrant price regulation or the imposition of a cap
20 on CLEC access rates (even if assuming for the sake of argument that such a cap
21 was warranted in 2001 in the first place).

22 **Q. WHAT CHANGES IN THE TELECOMMUNICATIONS INDUSTRY**
23 **HAVE OCCURRED SINCE 2001 THAT MAKE A CLEC ACCESS RATE**
24 **CAP UNWARRANTED?**

⁵¹ *CLEC Access Charge Order*, ¶7. (Emphasis added)

⁵² Footnote omitted.

1 A. In its *CLEC Access Charge Order*, the FCC noted that in an earlier order, it had
2 recognized the presumptively competitive nature of CLEC exchange access
3 services:

4 [A]s CLECs attempted to expand their market presence, the rates of
5 incumbent LECs or other potential competitors should constrain the
6 CLECs' terminating access rates. The Commission found that access
7 customers likely would take competitive steps to avoid paying
8 unreasonable terminating access charges. Thus, it explained that a call
9 recipient might switch to another local carrier in response to incentives
10 offered by an IXC.⁵³

11 When the FCC revisited the issue in its 2001 *CLEC Access Charge Order*, it came
12 to a somewhat different conclusion. The FCC noted:

13 We decline to conclude, in this order, that CLEC access rates, across the
14 board, are unreasonable. Nevertheless, there is ample evidence that the
15 combination of the market's failure to constrain CLEC access rates, our
16 geographic rate averaging rules for IXCs, the absence of effective limits
17 on CLEC rates and the tariff system create an arbitrage opportunity for
18 CLECs to charge unreasonable access rates. Thus, we conclude that some
19 action is necessary to prevent CLECs from exploiting the market power in
20 the rates that they tariff for switched access services.⁵⁴

21 However, while the FCC concluded in 2001 that CLECs may have been able to
22 exploit market power, it is important to note that the FCC identified *two*
23 *developments* that would make exchange access (or switched access) markets
24 competitive:

⁵³ *CLEC Access Charge Order*, ¶14 (footnotes omitted), referencing *In the Matter of Access Charge Reform; Price Cap Performance Review for Local Exchange Carriers; Transport Rate Structure and Pricing End User Common Line Charges*; First Report and Order, CC Docket No. 96-262; CC Docket No. 94-1; CC Docket No. 91-213; CC Docket No. 95-72; FCC 97-158, 12 FCC Red 15982; 1997 FCC LEXIS 2591, May 16, 1997 ("*Access Charge Reform Order*").

⁵⁴ *CLEC Access Charge Order*, ¶34 (footnote omitted).

1 The Commission previously projected that, at least in the case of
2 originating access service, IXCs would likely enter marketing alliances
3 with LECs offering low-priced access service and would thereby be able
4 to exert downward pressure on CLEC access rates. The Commission even
5 raised the prospect that IXCs would themselves choose to enter the local
6 service market as a means of exerting downward pressure on terminating
7 rates.⁵⁵

8 That is, according to the FCC, exchange access markets would discipline CLEC
9 exchange access rates if the following occurred: (1) alliances between IXCs and
10 ILECs and (2) IXC entry into local exchange markets. In 2001, the FCC
11 lamented that neither of these developments had yet come to pass and,
12 accordingly, the FCC concluded that CLECs must have market power in the
13 provision of exchange access services.⁵⁶ Of course, what the FCC was hoping for
14 in 2001 in order to make access services competitive – (1) alliances between IXCs
15 and ILECs and (2) IXC entry into local markets – now *has* come to pass. So,
16 while the FCC has yet to modify its “transitional” mechanism (in large part due to
17 all of the other intercarrier compensation issues on which the FCC has yet to take
18 action), it should not be viewed as an indication that a state commission should
19 follow suit on the intrastate level, as doing so would apply an outdated regulatory
20 “fix” to a marketplace that is significantly different than the market for which the
21 “fix” was designed.

⁵⁵ CLEC Access Charge Order, ¶32 (footnotes omitted).

⁵⁶ CLEC Access Charge Order, ¶32 states as follows: “However, neither of these eventualities has come to pass, at least not to an extent that has resulted in effective downward competitive pressure on CLEC access rates. We now acknowledge that the market for access services does not appear to be structured in a manner that allows competition to discipline rates.”

1 **Q. HOW HAVE THESE PRECONDITIONS FOR A FUNCTIONING ACCESS**
2 **MARKET SINCE COME TO PASS?**

3 A. All RBOCs have obtained Section 271 approval to provide interLATA long
4 distance services, and perhaps more importantly, there have been a number of
5 mergers between major IXC's (and CLECs) and ILECs – most notably the mergers
6 between AT&T and SBC and between Verizon and MCI.⁵⁷ These changes have
7 transformed the traditional ILECs into vertically-integrated firms offering both
8 local and long distance services (including competitive local exchange services in
9 Arizona). These changes brought about by Section 271 approvals and the
10 mergers impact rebut any suggestion that CLECs might exercise market power
11 and prevent IXC's from entering the market.

12
13 **It is Standard Regulatory Practice to Set Wholesale Rates Based on Company**
14 **Specific Costs**

15
16 **Q. HOW DO REGULATORS TYPICALLY SET REGULATED**
17 **WHOLESALE RATES FOR LECS?**

18 A. It is standard practice to set regulated rates for wholesale services based on
19 company specific costs. This is true for all wholesale services offered by ILECs
20 under Section 251 of the Telecommunications Act of 1996: UNE rates for all
21 unbundled network elements are to be set at company specific TELRICs. Most

⁵⁷ Qwest-Arizona obtained Section 271 authority in 2003. SBC and AT&T merged in 2005. Verizon and MCI merged in 2005.

1 other regulated wholesale services offered by ILECs have also been set in
2 reference to those companies' own costs, and not based on proxy companies.

3 **Q. ARE SWITCHED ACCESS SERVICES WHOLESALE SERVICES?**

4 A. Yes. And as such – and in line with standing practices – if the Commission
5 decides to regulate CLEC switched access rates, rates for switched access services
6 should be set at company specific costs.

7
8 **The IXCs' Calls to Reduce CLEC Access Rates Are Hypocritical and Self-Serving**

9
10 **Q. WHY ARE THE IXCS' CALLS TO REDUCE CLEC ACCESS RATES IN**
11 **ARIZONA ARE HYPOCRITICAL AND SELF-SERVING?**

12 A. They are hypocritical and self-serving for three reasons. First, IXCs in question
13 (AT&T and Verizon) appear to forget that they are vertically and inter-modally
14 integrated companies – companies that are the two *largest* ILECs, the two *largest*
15 wireless carriers and what used to be the two most vocal (in the regulatory arena)
16 CLECs in the nation. AT&T is complaining that “[o]ne CLEC has intrastate
17 terminating access charges of over 4.2 cents per access minute, while its
18 corresponding interstate charges are less than half a penny.”⁵⁸ AT&T neglects to
19 mention that *its own* CLEC intrastate switched access rate in Arizona is also “over

⁵⁸ *Comments of AT&T* dated January 7, 2008, p. 2.

1 4.2 cents” per terminating minute,⁵⁹ while its interstate charges are also “less than
2 half a penny.”⁶⁰ If AT&T were sincere in its concerns that 4.2 cent per minute
3 rates are high and “[t]he implicit subsidies in switched access rates and the
4 economic reactions that they trigger are harming Arizona consumers and the
5 Arizona telecommunications market[.]”⁶¹ AT&T could have reduced its own
6 CLEC intrastate switched access rates in Arizona to the levels it is advocating. Of
7 course, AT&T is not willing to forgo its switched access revenue.

8 Verizon argues, “economically efficient competition and the consumer benefits it
9 yields cannot be achieved as long as carriers seek to recover a disproportionate
10 share of their costs from other carriers, rather than from their own end users.”⁶²
11 Yet it fails to mention that this is exactly what Verizon seeks to do. Verizon (and
12 AT&T) advocate that the rates they pay to use a carriers network be shifted from
13 the IXC and onto all customers and carriers doing business in Arizona, whether or
14 not they are using the network that is being utilized by the IXC. Shifting expense

⁵⁹ See *AT&T Communications of the Mountain States, Inc. Arizona Access Services And Network Interconnection Services Price List*, p. 22. AT&T’s composite terminating rate is \$ 0.04223, calculated as the sum of the following three tariff rates: terminating switching charge (\$0.041500 per minute), tandem transport terminating per minute charge (\$0.000480) and tandem transport facility per minute-mile charge (0.000025) assuming 10 mile transport. Note that AT&T’s composite originating rate is \$0.02803, calculated as the sum of the originating switching charge (\$0.027300 per minute) and the above listed tandem transport termination and facility charges. These rates are summarized in table 1.

⁶⁰ *Comments of AT&T* dated January 7, 2008, p. 2. AT&T’s CLEC interstate access rates can be found in AT&T Communications Tariff FCC No. 28 at:
<http://www.serviceguide.att.com/ABS/ext/doc/Tariff%2028%20Master%20v741.pdf>

⁶¹ *Comments of AT&T* dated January 7, 2008, p. 7.

⁶² *Verizon’s Reply Comments*, February 4, 2008, p. 3.

1 from the cost causer, the IXC, to all carriers and their end users in Arizona is
2 exactly the action of which Verizon warns.

3 Second, AT&T's concern that switched access rates are "in excess of the rates
4 necessary to adequately recover costs"⁶³ is hypocritical because many of its own
5 rates are above cost and/or above AT&T cost estimates. One example is AT&T's
6 advocacy in the Federal intercarrier compensation docket, where AT&T filed a
7 letter stating that the per-minute switching costs for carriers should be in the range
8 between \$0.00010 and \$0.00024 per minute.⁶⁴ AT&T's own switched access
9 rates for local switching element are significantly higher: As mentioned above, in
10 Arizona AT&T's intrastate access local switching rate is \$0.041500 per
11 terminating minute and \$0.02803 per originating minute,⁶⁵ which is between *one*
12 *hundred and four hundred times*⁶⁶ higher than AT&T's own cost estimates for this
13 functionality. Also higher than its cost estimates are interstate switched access
14 rates of AT&T RBOC companies: Compare the above mentioned AT&T cost
15 estimates (between \$0.00010 and \$0.00024 per minute) to AT&T interstate local

⁶³ *Comments of AT&T* dated January 7, 2008, p. 7.

⁶⁴ Letter from Henry Hultquist, Vice President-Federal Regulatory, AT&T Services, Inc. to Marlene H. Dortch, Secretary, Federal Communication Commission in dockets *Developing a Unified Intercarrier Compensation Regime*, CC Docket No. 01-92; *High-Cost Universal Service Support*, WC Docket No. 05-337; *Federal-State Joint Board on Universal Service*, CC Docket No. 96-45; *Intercarrier Compensation for ISP-Bound Traffic*, WC Docket No. 99-68; *Establishing Just and Reasonable Rates for Local Exchange Carriers*, WC Docket No. 07-135 dated October 13, 2008, p. 5.

⁶⁵ *AT&T Communications of the Mountain States, Inc. Arizona Access Services And Network Interconnection Services Price List*, p. 22.

⁶⁶ Calculated as \$0.02803 divided by \$0.00024 (=117 times) and \$0.041500 divided by \$0.00010 (=415 times).

1 switching rates of \$0.003133 (SNET, Connecticut),⁶⁷ \$0.003116 (Ameritech
2 region),⁶⁸ \$0.00262 (Pacific Bell),⁶⁹ \$0.002563 (SWBT region),⁷⁰ and \$0.002158
3 (BellSouth region).⁷¹ These rates are *by an order of a magnitude* higher than
4 AT&T cost estimates, meaning that by AT&T's own account, its interstate access
5 local switching service brings margins in the vicinity of *one thousand percent*.⁷²
6 However, AT&T has not argued that its own CLEC rates are excessively high,
7 unjust, unreasonable, or in urgent need of reduction through regulation.

8 Note that Qwest's interstate access local switching rate is \$0.001974,⁷³ meaning
9 that based on AT&T cost estimates, Qwest's interstate rate contains at least a
10 700% margin ($=\$0.001974/\$0.00024 - 1$).

11 Third, while Verizon and AT&T advocate that this Commission not wait for the
12 FCC to act on intercarrier compensation, they have the exact opposite position
13 with respect to the AUSF recovery mechanism. AT&T and Verizon ask this
14 Commission to follow any actions taking by the FCC with regard to funding
15 universal service.⁷⁴ This advocacy is a result of AT&T's and Verizon's proposal

⁶⁷ See *SNET Tariff FCC No. 39*, Section 6, p. 6-64.

⁶⁸ See *Ameritech Tariff FCC No. 2*, Section 6, p. 214.

⁶⁹ See *Pacific Bell Tariff FCC No. 2*, Section 6, p. 6-220.

⁷⁰ See *SWBT Tariff FCC No. 73*, Section 6, p. 6-185.

⁷¹ See *BellSouth Tariff FCC No. 1*, Section 6, p. 6-161.

⁷² Margin is defined as a ratio of rate and cost minus 1. For example, for Ameritech, interstate local switching rate of \$0.003116 in combination with the upper boundary of AT&T local switching cost estimate (\$0.0024) produces a margin of 1,198% ($=\$0.003116$ divided by $\$0.0024$ minus 1).

⁷³ See *Qwest Tariff FCC No. 1*, Section 6, p. 6-433.

⁷⁴ See *AT&T's Issues Matrix and Procedural Recommendations*, October 7, 2008, p. 5 and *Verizon's List of Issues*, October 7, 2008, p. 4.

1 before the FCC to move USF contribution to a numbers based system. Because
2 IXC operations in a state tend to eclipse the IXC's CLEC operations, the proposal
3 to shift to a numbers based contribution mechanism for USF would provide
4 additional cost savings for IXCs at the further expense of Arizona end user
5 customers.

6 **Q. ARE THERE ANY OTHER EXAMPLES THAT ILLUSTRATE THAT**
7 **RBOCS RATES FOR CRUCIAL SERVICES SIGNIFICANTLY EXCEED**
8 **THEIR COST?**

9 A. Yes. Special access services are a good example. Traditionally, IXCs and large
10 business end-users were the typical buyers of these services. More recently,
11 following the TRO and TRRO (which removed the ILECs' obligation to provide a
12 number of UNE products such as high-capacity loops and transport at many wire
13 centers) these services became essential wholesale inputs for CLECs. Special
14 access services are priced significantly above the underlying economic cost, as
15 evidenced by a comparison of TELRIC-based rates for ILEC UNE services with
16 the rates for their special access counterparts.

17 Specifically, the following table illustrates this point by presenting "margins" by
18 which Qwest Arizona and AT&T Illinois (picked as an example of AT&T
19 companies) special access rates exceed the UNE rates of their functional
20 equivalents. Here "margins" are defined as a ratio between a special access rate
21 and UNE rate minus one. Because UNE rates are set based on TELRIC cost plus

1 shared and common cost, the calculated “margins” represent the degree by which
2 special access prices exceed economic cost (cost that include capital cost,
3 expenses and reasonable profit). For example, a margin of 63% means that
4 special access rate is equal to UNE cost-based rate plus a 63% markup, or,
5 equivalently, that special access rate is 1.63 times higher than the corresponding
6 UNE rate.

Table 2. Margins by Which RBOCs Special Access Rates Exceed Comparable UNE Rates*

Network Element / Service	Qwest Intrastate over UNE		Qwest Interstate over UNE		AT&T Illinois Interstate over UNE	
	Monthly	60-Mo. Term	Monthly	60-Mo. Term	Monthly	60-Mo. Term **
<u>DS1 Loop / Local Distribution Channel</u>						
Lowest Zone	123%	63%	145%	63%	802%	308%
Highest Zone	97%	45%	143%	71%	495%	184%
<u>DS1 Transport -- Termination</u>						
Lowest Zone	456%	289%	156%	122%	462%	75%
Highest Zone	456%	289%	156%	122%	522%	254%
<u>DS1 Transport -- Mileage</u>						
Lowest Zone	1496%	1070%	1602%	964%	1331%	815%
Highest Zone	1496%	1070%	1602%	964%	1863%	852%
<u>DS3 Transport -- Termination</u>						
Lowest Zone	141%	93%	164%	83%	308%	63%
Highest Zone	141%	93%	164%	83%	383%	121%
<u>DS3 Transport -- Mileage</u>						
Lowest Zone	121%	77%	435%	328%	524%	13%
Highest Zone	121%	77%	435%	328%	675%	64%

* -- Derived from Qwest Arizona and AT&T Illinois tariff rates. Margins defined as "Special Access Rate divided by UNE Rate minus 1." Table reflects pricing flexibility special access rates. Pricing flexibility rates for both local and transport channels elements apply in Phoenix MSA.

** -- Effective 7/1/10: Per Tariff AT&T Illinois FCC No. 2, Section 21, pp. 755.1, 757, 759, 783 and 784, "[t]emporarily reduced rate pursuant to the AT&T/BellSouth Merger Commitment No. 6 of the F.C.C. Memorandum Opinion and Order, WC Docket No. 06-74, in The Matter of AT&T, Inc. and BellSouth Corporation Application for Transfer of Control. Customers subscribing to or renewing term plans from April 5, 2007 through June 30, 2010, will be charged the rates in Section 21.5.2.7.1 effective July 1, 2010."

As shown in the table above, special access rates of both Qwest and AT&T exceed cost-based rates of their functional UNE equivalents by very large margins. For example, Qwest's intrastate special access rates for services

1 purchased on a month-by-month basis⁷⁵ range from 63% (DS1 local channel) to
2 1496% (DS1 transport mileage). This means that the DS1 rate is 1.63 times its
3 economic cost and the DS1 transport mileage rate is almost 15 times its economic
4 cost. Similarly, intrastate special access rates for services purchased on a 60-
5 months term contract range from 45% (DS1 local channel) to 1070% (DS1
6 transport mileage). Qwest's interstate special access margins are generally of
7 similar order. AT&T's interstate special access margins are also very high, with
8 sixteen out of the total twenty margin measures in this table being in triple or
9 quadruple digits.

10 These high margins translate into very large total dollar amounts. Specifically,
11 Qwest Arizona and AT&T Illinois each earn special access services revenue in
12 the vicinity of a *half a billion* dollars annually.⁷⁶ Table 3 below shows a broader,
13 nationwide view by depicting the annual 2008 revenue for the RBOCs (Qwest,
14 AT&T and Verizon), as well as Arizona's largest rural ILEC, Frontier, compared
15 to the annual 2008 revenue for the Joint CLECs.⁷⁷

⁷⁵ Month-by-month special access rates are typically the highest special access rates available. They represent the closest contract terms when compared to UNEs because UNE products are leased on month-to-month basis.

⁷⁶ Based on the most recent data available (which is ARMIS report 43-04, row 4012 for year 2007), Qwest Arizona annual special access revenue subject for separations (interstate and intrastate) was \$415,659,000, and AT&T Illinois's annual special access revenue subject for separations was \$624,611,000.

⁷⁷ All companies, except for Integra, are publically traded and thus file revenue annually with the SEC. Their revenues were compiled from their 10-K and/or Annual Reports for 2008. Integra's revenue is based on a news release where it stated it had nearly \$700 million in revenue in 2008 (see 2/10/09 press release at http://www.integratelecom.com/about/news/press_releases.php).

Table 3. Comparison of Annual Revenue Nationwide (2008)

Company	2008 Annual Revenue (millions)	% of AT&T Revenue	% of Verizon Revenue	% of Qwest Revenue
Integra	\$700	0.6%	0.7%	5.2%
Paetec	\$1,570	1.3%	1.6%	11.7%
tw telecom	\$1,159	0.9%	1.2%	8.6%
XO	\$1,478	1.2%	1.5%	11.0%
Frontier	\$2,237	1.8%	2.3%	16.6%
Qwest	\$13,475	10.9%	13.8%	100.0%
AT&T	\$124,028	100.0%	127.4%	920.4%
Verizon	\$97,354	78.5%	100.0%	722.5%

As shown in Table 3 above, on a nationwide scale⁷⁸ all four joint CLECs are significantly smaller than AT&T, Verizon or Qwest, and even smaller than Arizona's largest rural ILEC, Frontier. Because *total* revenue of a CLEC such as Integra Telecom constitutes a very small fraction of the RBOCs revenue, this underscores the point I made above: That the regulators' priorities should be to address above-cost rates of large ILECs rather than spend energy on the subject of CLEC access rates – the subject that is, while important for each individual CLEC, has a very small overall impact on the Arizona telecommunications market.

⁷⁸ There is no public data to make a similar comparison for the state of Arizona.

If Cost is Not Used to Set Access Rates, then for CLECs Competing in the Qwest Territory, Qwest's 1999 Access Rates Should be Used

Q. IF THE COMMISSION ELECTS TO ESTABLISH A BENCHMARK FOR CLEC ACCESS RATES OTHER THAN COST, WHAT SHOULD THAT BENCHMARK BE?

A. If this Commission does decide to mandate CLEC access rate reductions with a target other than cost, then the Commission should establish a benchmark rate for CLECs competing in the Qwest territory equal to Qwest's intrastate switched access rates from the 1999 time period. First, this is the time period when most CLECs were entering the competitive market. These rates would have been considered when CLECs made the determination on whether they could enter and compete in local markets. In addition, as discussed previously, changes to these rates since 1999, were the result of a series of revenue neutral settlement agreements entered into by Qwest for Qwest's benefit. There is no justification to apply reductions agreed to by Qwest to Qwest's competitors. Finally, it should also be noted, that when reviewing the rates in table 1, most CLECs, including the CLEC operations of AT&T and Verizon have rates that are similar to the rates that existed for Qwest in 1999.

Q. PLEASE SUMMARIZE ISSUE 2.

A. Carrier-own cost is the only reasonable benchmark for its access rates. Qwest's intrastate and interstate access rates were set based on horse-trading

1 considerations, and as such, are not based on Qwest's cost. However, even if
2 Qwest's rates *were* set based on Qwest's cost, these rates and cost have no
3 correlation to CLECs (or rural ILECs) cost. As new entrants, CLECs (as well as
4 small ILECs) lack the economies of scope and scale enjoyed by the Bell
5 Companies, and therefore, have higher access cost than RBOCs. Reducing CLEC
6 access rates to RBOC rates would impose great economic harm on CLECs –
7 carriers who could not possibly make up for lost access revenues via increases
8 solely in end user charges. The Commission should discard calls to use Qwest's
9 intrastate or/and interstate switched access rates as benchmarks for other carriers.

10
11 **Issue 3. What procedures should the Commission implement to achieve the**
12 **desired reduction in access rates?**

13
14 **Reduction in Access Rates Should be Implemented Gradually to Allow LECs**
15 **Adequate Opportunity to Adjust Their Business Plans**

16
17 **Q. WHY SHOULD THE COMMISSION IMPLEMENT ACCESS RATE**
18 **REDUCTIONS GRADUALLY?**

19 **A.** The Commission should implement access rate reductions gradually over a time
20 period sufficient for LECs to adjust their business plans. This is particularly
21 important because carriers at issue in this proceeding are small carriers (when
22 compared to Qwest – see table 3 above), and therefore, have smaller financial
23 resources and less of an ability to absorb financial losses than a large company

1 such as Qwest. Similarly, to the extent access rate reductions cause increases in
2 end-user rates, gradual transition would help cushion the impact of the reform on
3 end-users and minimize market disruptions. A sufficiently long transition period
4 would also allow LECs the opportunity to develop their switched access cost
5 studies, which, as I discuss above, are the only proper measure of the
6 reasonableness of rates.

7 There are many examples of gradual implementation of access reductions. For
8 example, in its FNPRM on Intercarrier compensation,⁷⁹ the FCC proposed a 10-
9 year transition period of intrastate switched access rates to the levels envisioned
10 by the FCC.⁸⁰ In the *CLEC Access Charge Order* and *CALLS Order* the FCC
11 adopted a three-year transition period.⁸¹

12 **Q. WHAT SHOULD BE THE DURATION OF THE TRANSITION PERIOD**
13 **AND THE TRAJECTORY OF RATE REDUCTIONS?**

⁷⁹ In the Matter of *High-Cost Universal Service Support*, WC Docket No. 05-337, *Federal-State Joint Board on Universal Service*, CC Docket No. 96-45, *Lifeline and Link Up*, WC Docket No. 03-109, *Universal Service Contribution Methodology*, WC Docket No. 06-122, *Numbering Resource Optimization*, CC Docket No. 99-200, *Implementation of the Local Competition*, CC Docket No. 96-98, *Provisions in the Telecommunications Act of 1996*, CC Docket No. 01-92, *Developing a Unified Intercarrier Compensation Regime*, CC Docket No. 99-68, *Intercarrier Compensation for ISP-Bound Traffic IP-Enabled Services*, WC Docket No. 04-36, *Order On Remand And Report And Order And Further Notice Of Proposed Rulemaking*, released November 5, 2008 ("FNPRM").

⁸⁰ FNPRM, Appendix A, ¶¶192-196. While the FNPRM proposed a 10 year transition, it did not mitigate the impact of proposed rate changes by smoothing out reductions over the transition. Instead the FNPRM proposed the most substantial reductions in the first two years and minor reductions thereafter. A 10 year transition of this nature does little to allow CLECs the ability to rationally adjust and plan its business.

⁸¹ See *CLEC Access Charge Order*, Appendix B "Final Rules," and 47 C.F.R. § 61.26(c) and See *CALLS Order*, ¶¶30, 35 and 196.

1 A. The Commission should recognize that a flash cut from one regime to another
2 could cause massive marketplace disruptions to Arizona carriers and end-users.
3 To minimize these disruptions, the Commission should set the duration of the
4 transition period to be *at least* five to seven years. More importantly, the
5 Commission should not mandate any reductions in the CLECs access rates *for the*
6 *first three years*. This is necessary because, as explained in McLeodUSA
7 comments,⁸² CLECs will require a longer period to adjust their business plans due
8 to the nature of their existing customer base: CLECs serve primary business
9 markets and typically have long-term contracts with their business customers.
10 McLeod explains that it has service agreements with virtually 100% of its existing
11 business customers, with average service agreement being 4.2 years.⁸³ Because
12 prices that CLECs charge end-users are often fixed during the term of the end-
13 user agreement, CLECs would not be able to increase end-user prices for existing
14 term customers to compensate for lost access revenue. In contrast, ILECs are
15 more likely to rely on month-to-month end user pricing, meaning that they have
16 the ability to quickly increase end-user rates if allowed to do so by the
17 Commission.

18 Many LECs purchase long distance at wholesale from carriers such as AT&T and
19 Verizon. These contracts can contain term commitments and pricing that are not
20 dependent upon changes in access rates. As a result, if access reductions are

⁸² McLeodUSA Statement of Position dated October 7, 2008.

⁸³ McLeodUSA Statement of Position dated October 7, 2008, p. 3.

1 mandated by this Commission with immediate implementation, LECs may end up
2 paying wholesale rates that do not reflect these reductions. It is my understanding
3 that IXC's have not committed to flow through access reductions to Arizona
4 carriers or end users using the IXC's network. Immediate implementation of
5 reductions could result in a windfall, not just from the reduction in rates, but the
6 fact that wholesale long distance rates would not be immediately reduced to
7 reflect the cost reductions.

8 Another factor that can aggravate the CLECs' situation is that business customers
9 can generate higher calling (and access) volumes than residential customers. In
10 other words, because of the nature of CLEC customers (who are predominantly
11 business customers), CLECs could be more vulnerable to mandatory access rate
12 reductions than a typical ILEC that serves higher portion of residential (low
13 volume) customers.

14
15 **Access Rate Reductions Should be Implemented in Separate Proceedings on a Case-**
16 **by-Case Basis**

17
18 **Q. IF THE COMMISSION DECIDES TO MANDATE ACCESS RATE**
19 **REDUCTIONS, WHY SHOULD THESE REDUCTIONS BE**
20 **IMPLEMENTED IN SEPARATE PROCEEDINGS?**

21 **A.** Initially, the Commission should decide on the policy issues, such as to what
22 carriers intrastate switched access rate changes should apply, the appropriate

1 margins above cost the Commission will allow; target rates that the Commission
2 may wish to impose in the event an access cost study is not available, the
3 transition period, and how access cost recovery mechanisms, if any, will be
4 established and funded. Decisions at each stage will affect the specifics of the
5 implementation stage. For example, if the Commission decides that access
6 charges should be cost-based, the carriers should be given the opportunity to
7 produce switched access cost studies. The timing of individual carriers in
8 producing cost studies would likely be different (because some carriers may have
9 already have a cost study, and others may not); therefore, it makes sense to
10 consider these cost studies in a separate docket.

11 Further, a record has not been developed upon which to base any assumptions
12 about whether switched access charges contain implicit subsidies. The existence
13 of and magnitude of such alleged subsidies should first be investigated and
14 determined before any decisions affecting business (and likely, viability) of
15 individual companies are made. Mandatory (potentially, confiscatory) rate
16 reductions should not be implemented based on an assumption that has not been
17 proven. Furthermore, even if such charges may include some implicit subsidies,
18 the amount would likely depend on the cost structure and individual
19 characteristics of each company. Because different companies have different unit
20 costs due to economies of scale or other reasons, the amount or existence of such
21 a subsidy cannot be assumed to be uniform.

1 In short, the Commission should avoid a "cookie-cutter" approach to access
2 charges. The Commission should consider the unique characteristics of the
3 various telecommunications providers, including the broad variations that occur
4 between CLECs and rural ILECs in determining access charge policy.

5 **Q. PLEASE SUMMARIZE ISSUE 3.**

6 A. To summarize, in order to allow the carriers an opportunity to adjust their
7 business plans, a transition period should be at least five to seven years, and no
8 changes should be instituted earlier than three years out from whenever a final
9 ruling becomes effective. Further, implementation of access reduction should
10 proceed on a case-by-case, company-by-company basis.

11
12 **Issue 4. Should carriers be permitted to contract for access rates that differ from**
13 **their tariffed rates?**

14
15 **Carriers Should be Required to Pay Tariff Access Rates**
16

17 **Q. SHOULD IXCS BE REQUIRED TO PAY TARIFFED INTRASTATE**
18 **SWITCHED ACCESS RATES?**

19 A. Yes. Failure to require IXCs to pay tariffed access rates would only allow IXCs
20 to exploit their market power in the access market.

21 **Q. ARE YOU SAYING THAT LARGE IXCS HAVE SOME DEGREE OF**
22 **MONOPOLY POWER IN PURCHASING ACCESS SERVICES?**

1 A. Yes. Economists define such markets where a single or few dominant buyers can
2 effectively set prices as “monopsonistic” or “oligopsonistic.”⁸⁴ These concepts
3 are similar to the more commonly used concepts of “monopoly” and “oligopoly”
4 wherein a single or few *sellers* can influence prices. In monopsonistic or
5 oligopsonistic markets dominant *buyers* can influence prices, and individual
6 sellers have little choice but to accept prices and/or terms dictated by those
7 buyers.

8 In access markets, a significant portion (60% or more) of all long distance traffic
9 received by CLEC customers is carried to the CLEC networks by two IXC's,
10 AT&T and Verizon. Further, because a CLEC (or any LEC) bills IXC's *after the*
11 fact (for originating or terminating access service that has been provided), IXC's
12 have an additional bargaining power because they can simply refuse to pay the
13 bills. A CLEC (or any LEC) cannot refuse to terminate a call that has already
14 been completed. Similarly, a CLEC (or any LEC) cannot refuse to terminate
15 future calls from a non-paying IXC because by doing so, the CLEC will be doing
16 disservice to its own end users.

17 **Q. HOW WOULD THIS SCENARIO, IN WHICH IXCS AVOID PAYING**
18 **CLEC ACCESS CHARGES, PLAY OUT IN THE REAL WORLD?**

⁸⁴ See F.M. Scherer and David Ross. *Industrial Market Structure and Economic Performance*, 3rd Edition, Houghton Mifflin Company, Boston, p. 17, noting that definitions of the buyers' market structures are “symmetric” to the definitions of the seller's market structures. Specifically, “[w]hen some buyers can perceptibly influence price, *monopsony* is said to exist.” See also p. 79 noting that oligopsony is a market with few buyers.

1 A. Yes. This scenario does play out in real life.⁸⁵ A large IXC stops paying the
2 CLEC's intrastate tariffed rate and informs the CLEC that it believes the switched
3 access rate is too high – even if the rates have been tariffed and approved by the
4 relevant state utility commission. Given that this IXC may by itself represent a
5 large portion of the CLEC's total switched access revenue, unpaid invoices stack
6 up quickly, resulting in a large unpaid balance and a significant drain on the
7 CLEC's cash flow necessary for operations. In the end the CLEC is bullied into
8 accepting partial payment for its access invoices to this IXC.

9
10 **Issue 5. What revenue sources should be made available to carriers to compensate**
11 **for the loss of access revenues?**

12
13 **Revenue Source Made Available to Compensate for Lost Access Revenue Should**
14 **Not Lock Arizona Consumers into Support that May Not be Necessary in the**
15 **Future**

16
17 **Q. IF THE COMMISSION DECIDES TO REDUCE LEC ACCESS RATES,**
18 **SHOULD LECS BE GRANTED A REVENUE-NEUTRAL OFFSET OF**

⁸⁵ Most recently, this scenario (where CLECs received rates lower than their tariff access rates from AT&T following AT&T refusal to honor tariff rates) was documented in the ongoing proceeding before the Colorado Public Utilities Commission docket No. 08F-259T *Qwest Communications Company, LLC, Complainant v. MCI Metro Access Transmission Services, LLC, XO Communications Services, Inc., Time Warner Telecom Of Colorado, L.L.C., Granite Telecommunications, Inc., Eschelon Telecom, Inc., Arizona Dialtone, Inc., ACN Communications Services, Inc., Bullseye Telecom, Inc., Comtel Telecom Assets LP, Ernest Communications, Inc., Level 3 Communications, LLC, and Liberty Bell Telecom, LLC*. See also a 2004 proceeding in Minnesota *In the Matter of the Complaint of the Minnesota Department of Commerce for Commission Action Against AT&T Regarding Negotiated Contracts for Switched Access Services*, Docket Nos. P-442, 5798, 5826, 5025, 5643, 443, 5323, 5668, 4661/C-04.

1 **THE LOSS IN ACCESS REVENUES STEMMING FROM THE**
2 **COMMISSION'S DECISION?**

3 A. Not automatically. While it is critically important to recognize that regulated
4 rates should not be reduced without considering carriers' legitimate rights to
5 recover their costs, carriers should not be given an automatic and *guaranteed*
6 revenue-neutral offset. For example, granting revenue-neutral offset in the form
7 of an access charge recovery fund (i.e. AUSF) would mean that Arizona
8 consumers are locked forever (or until another Commission's action) into support
9 levels that may not be necessary in the future. Specifically, shifts in population,
10 technological advancements or other changes in conditions that affect cost of or
11 demand for telecommunications services may reduce or eliminate the need for
12 AUSF support for individual carrier.⁸⁶ As a result, a stream of support locked at
13 historical levels would result in unwarranted (and undesirable from the public
14 interest standpoint) subsidies for this carrier.

15 **Q. WHAT REVENUES SHOULD THE COMMISSION MAKE AVAILABLE**
16 **TO LECS TO COMPENSATE FOR LOSS IN ACCESS REVENUE**
17 **STEMMING FROM THE REDUCTION IN ACCESS RATES?**

18 A. There are two general types of potential revenue sources that carriers can use to
19 compensate for the loss of access revenue: End-user rates or an access revenue

⁸⁶ As an example, ten or twenty years ago, a LEC was able to offer only voice telephony over its loop facilities. Today, loop facility can also carry high-speed Internet and video services. If a carrier starts offering such triple play products (voice/Internet/video), this carrier's revenue streams would increase significantly, likely eliminating the need to "subsidize" local service from public sources.

1 recovery fund, such as AUSF support. The advantage of the first source (from the
2 standpoint of the public interest) is that it does not automatically lock Arizona
3 consumers into current levels of "implicit subsidies."⁸⁷ high local rates could
4 attract competition, and rates could eventually be "competed down." The second
5 source, AUSF, can be designed to allow support to fluctuate with the need, but
6 this design would likely include high administrative costs.⁸⁸

7 To summarize, when considering the source of revenue that the Commission may
8 make available to compensate for lost access revenue, the Commission should not
9 guarantee revenue-neutral offsets and should choose revenue sources that
10 fluctuate in amount as need is verified. The Commission should recognize that
11 whether access revenue recovery is achieved directly through end-user rate
12 increases or a state access revenue recovery fund, ultimately end user customers
13 in Arizona are going to pay for access cost reductions that primarily benefit the
14 large IXC's.

15 **Q. WILL CLECS BE ABLE TO BENEFIT FROM ANY ALTERNATIVE**
16 **REVENUE STREAMS?**

17 A. No. As explained below, if the Commission lowers CLEC switched access rates,
18 CLECs will not be able to benefit from any alternative revenue streams the
19 Commission may make available to the ILECs. This further underscores how

⁸⁷ I use the term "implicit subsidy" assuming that the Commission has made a determination that access rates paid to rural carriers exceeds the cost of providing the service.

⁸⁸ This design would require that the fund conducts periodic (such as annual) review of the LECs' financial need to funding.

1 inappropriate it is to benchmark CLEC switched access rates to those of the
2 ILECs.

3 First, CLECs have limited ability to individually pass through rate increases to
4 their customers. By definition, CLECs exist in competitive retail markets –
5 CLECs are firms that enter markets already served by one or more carriers. The
6 price in this market is generally already set by the existing players. No customer
7 would switch to a CLEC's service unless it offers a competitive price and/or
8 superior service. As a result, a CLEC cannot successfully raise end user prices,
9 unless prices are increasing at the industry level – in other words, CLECs can
10 only sustain price increases when all firms in the market increase price. Because
11 CLECs are relatively small players in the market, compared with Qwest, the
12 dominant provider, a CLEC will have very little success increasing prices unless
13 Qwest is also increasing prices for that same customer class.

14 Second, it is unlikely, and not even advisable, that an access revenue recovery
15 fund be established for CLECs to recover lost access revenue. As mentioned
16 previously, these funds tend to take revenues that are subject to competition and
17 lock them into a fund that will likely never be decreased. The value of such a
18 fund in a competitive market is questionable. Further, I am not aware of any state
19 that has established such a fund for CLEC access revenue recovery.

20

1 **Issue 6. How much of access cost recovery, if any, should be shifted to end users?**
2 **What showing should be required for such a shift? What should be the**
3 **role of “benchmark” rates and how should benchmarks be set?**

4
5 **IXCs and Their Customers Are the Cost Causers of Traffic Sensitive Costs and Not**
6 **End Users**

7
8 **Q. SHOULD THE TERM “ACCESS COST RECOVERY” AS USED IN ISSUE**
9 **6 BE CLARIFIED?**

10 A. Yes. Issue 6 appears to mix two different notions – (1) recovery of access cost,
11 and (2) recovery of non-access cost that is currently built into some access rates.
12 Access rates *should* recover access cost; therefore, no shifting of access cost *away*
13 *from* access rates should be done. Non-access cost that is currently built into
14 some access rates do constitute a subsidy, and should indeed be the subject of this
15 proceeding and Issue 6.

16 **Q. WHAT ABOUT CERTAIN ACCESS COST ELEMENTS, SUCH AS THE**
17 **COST OF LOCAL LOOP THAT IS OFTEN RECOVERED IN CARRIER**
18 **COMMON LINE (“CCL”) CHARGES?**

19 A. The presence of a CCL does not automatically imply that this rate is a subsidy:
20 The issue here is whether the *per minute* CCL charge properly recovers what
21 could be *non-traffic-sensitive* cost. The traditional FCC view has been that loop is
22 not a traffic-sensitive cost, and therefore, its costs should be recovered through a

1 per line charge.⁸⁹ However, even the FCC noted in its *Access Charge Reform*
2 *Order*, when setting the federal flat-rated mechanism for common line cost
3 recovery, that “[common line] costs should be assigned, where possible, to those
4 customers who benefit from the services provided by the local loop.”⁹⁰ The
5 customers that benefit from the local loop⁹¹ include IXC’s and their long-distance
6 subscribers. Therefore, it is reasonable to ask that IXC’s share the cost of the loop
7 in relative proportion to their use of the facility.⁹² In other words, if an IXC bears
8 no cost of the local facility that allows it to provide long-distance service, there
9 would be a subsidy flow from local exchange services to an IXC who is provided
10 access to the facility at no cost.

11 **Q. DOES IT MATTER WHETHER THE COST IS RECOVERED FROM AN**
12 **END-USER OR AN IXC GIVEN THAT IXCS ALSO SERVE END-USER**
13 **AND MAY PASS THEIR COST SAVINGS ON END-USERS?**

14 **A.** Yes, for a number of reasons.

⁸⁹ FCC, *In the Matter of Access Charge Reform, Price Cap Performance Review for Local Exchange Carriers, Transport Rate Structure and Pricing, End User Common Line Charges*, CC Docket No. 96-262, CC Docket No. 94-1, CC Docket No. 91-213, CC Docket No. 95-72, First Report and Order, adopted: May 7, 1997 (“Access Charge Reform Order”) ¶37. This order set the federal flat-rated mechanism for common line cost recovery.

⁹⁰ Access Charge Reform Order ¶77.

⁹¹ While it is true that end-users benefit not only from actual usage, but also from the “ability” to make the call, it would be improper to completely disregard the first benefit (actual usage).

⁹² Another relatively recent development that further underscores the notion that local loop is a shared and potentially traffic-sensitive facility is that CLECs offer integrated voice and data services over shared local loop facilities in which bandwidth is *dynamically re-allocated* to either voice or data based on current demand/usage. If voice long-distance traffic uses the loop, the smaller portion of the loop bandwidth capacity can be allocated to data services.

1 First, as is well established as a regulatory principle: the cost causer should pay,
2 lest undesirable subsidies are created. Given that end users are not a homogenous
3 group but are differentiated between providers and services, it is critically
4 important that regulators do not create subsidies between disparate groups of end
5 users.

6 Specifically, the IXC's end users are not the same as the CLECs' end users. For
7 example, AT&T may serve a large telephone solicitor in Phoenix who calls
8 residents in Tucson, including CLEC end users. There is no good justification for
9 having the CLEC's end users subsidize⁹³ AT&T's telephone solicitor business by
10 not assessing such calls the full long run incremental costs of such calls.
11 Assuming that many of the CLEC's end users may actually find such calls
12 annoying, it would be adding insult to injury to tell them they are in fact forced by
13 this Commission to subsidize such nuisance calls.

14 In general, the IXC's end users are the cost causers of long distance calls and the
15 associated switched access costs. There is no policy rationale to having other end
16 users – *who may make no long distance calls at all* – pay for the traffic sensitive
17 costs of switched access. In fact, such a policy is tantamount to a cross-subsidy
18 scheme.

⁹³ It is assumed here that benchmarked rates would not compensate CLECs for the costs of switched access services.

1 Further, it matters because IXC's would not necessarily pass these access cost
2 savings onto Arizona end-users. In fact, IXC's are misleading the Commission
3 with claims such as, "[t]he high access rates promoted by the current system
4 obviously distort Arizona telecommunications prices."⁹⁴ These claims are
5 misleading because they create false appearance that IXC's in-state pricing in
6 Arizona is linked to Arizona intrastate switched access rates. In reality, AT&T,
7 for example, offers the *same* in-state calling plans in Arizona and states with
8 "low" intrastate access rates, such as Nebraska and New Mexico.⁹⁵ While AT&T
9 also charges an "in-state connectivity fee," this charge does not appear to have a
10 link to intrastate access cost. Specifically, this fee is currently \$1.49 in Arizona,
11 \$1.63 in Nebraska and zero in New Mexico.⁹⁶ Yet, AT&T comments are
12 complaining that Arizona access rates are very high (citing average access rates of
13 3.1 cents for Qwest and 14 cents for Citizens⁹⁷), and pointing out intrastate rates
14 in New Mexico and Nebraska are at interstate levels (citing a 2-cent access rates
15 for rural carriers in Nebraska and 1.83 cent state wide average rate in New
16 Mexico⁹⁸). Clearly, there is no direct relation between AT&T "in-state
17 connectivity fee" and intrastate access rates because this fee is higher in Nebraska
18 than in Arizona, and absent in New Mexico, despite the fact (as presented by

⁹⁴ *Comments of AT&T* dated January 7, 2008, p. 2.

⁹⁵ Using AT&T's web site (<http://www.shop.att.com/plancomparison.jsp>), I reviewed residential calling plans in several states. These pricing plans appear to be identical. Based on the notes to these plans, Alaska is the only state where in-state calling is slightly different than in other states.

⁹⁶ See <http://www.consumer.att.com/instate-connectionfee/>.

⁹⁷ *Comments of AT&T* dated January 7, 2008, p. 6.

⁹⁸ *Comments of AT&T* dated January 7, 2008, pp. 9-10.

1 AT&T) that Nebraska and New Mexico have similarly “low” access rates, and
2 Arizona has “high” access rates.

3 In other words, because AT&T in-state calling plans are priced at “generic”
4 nationwide levels, a decrease in Arizona intrastate rates would likely not translate
5 into a rate decrease for Arizona long-distance customers of AT&T. Instead,
6 AT&T would simply pocket the access cost savings obtained at the Arizona
7 consumer expense and use them to “subsidize” its operations in other states or
8 simply flow through the savings to its shareholders.

9
10
11 **Issue 7. Procedurally what will be required of a carrier if it seeks a “revenue**
12 **neutral” increase in local rates?**

13 **Issue 8. Assuming that AUSF funds will also be used as a compensating revenue**
14 **source, what specific revisions (including specific recommended**
15 **amendment language) to the existing rules are needed to allow use of**
16 **AUSF funds for that purpose?**

17 **Issue 9. What carriers should be eligible for AUSF support?**

18 **Issue 10. What should be supported by AUSF? Access replacement only? High**
19 **cost loops? Line extensions? Centralized administration and automatic**
20 **enrollment for lifeline and Link-up?**

21
22 **The Use of AUSF Should be Limited, and Recipient Carriers Should Have to**
23 **Demonstrate the Need for Funding**

1 **Q. WHAT SHOULD THE COMMISSION CONSIDER WHEN DECIDING**
2 **ON WHETHER TO USE AUSF AS A “COMPENSATION” FOR**
3 **REDUCTION IN ACCESS RATES?**

4 **A.** First, as noted with regard to Issue 6, the Commission should make a clear
5 distinction between (1) recovery of access cost, and (2) recovery of non-access
6 cost that is currently built into some access rates. Access cost should be
7 recovered in access *rates*, not in AUSF. Shifting recovery of access cost to the
8 USF would be contrary to the goal of a USF fund, which is typically to ensure
9 connectivity to the network, and not to subsidize long-distance business.

10 Second, the Commission should make sure that any decision it makes regarding
11 access revenue replacement through AUSF is *competitively neutral*. Granting
12 revenue replacement for some carriers (ILECs) and not others (CLECs) is not
13 revenue neutral: CLECs are price takers in competitive markets, meaning that
14 they cannot increase its end-user rates beyond the market rates (and unless the
15 ILEC increases its rates). In other words, if the ILEC access revenues are
16 “replaced” by AUSF moneys, but CLECs competing with those same ILECs
17 cannot draw from AUSF, they would not be able to “replace” their lost access
18 revenue with increased end-user charges: If a CLEC attempts to do so, its end-
19 users would migrate to the ILEC (carrier that does not need to increase its end-
20 user rates to replace lost access revenue because it receives replacement support
21 from AUSF).

1 Third, because of the competitive neutrality implications, the Commission should
2 reject the notion of granting *revenue neutrality*. Instead, the Commission should
3 focus on funding situations where the carrier has a real *need that is in public*
4 *interest*. Subsidizing *high cost* areas and services for low income customers are
5 indeed the cases of real need from the standpoint of public interest. Subsidizing
6 out-of-state IXC's and extraordinary returns of ILECs are not cases of real need.
7 Funding for line extensions (construction of loop facilities to areas outside the
8 range of pre-existing outside loop plant) likely is unnecessary because
9 extraordinary construction cost of line extensions are typically addressed in
10 special construction tariffs.⁹⁹ Therefore, in order for a carrier to draw from the
11 fund, it should be required to demonstrate the "public interest" need.

12 **Q. PROCEDURALLY, WHAT SHOULD BE REQUIRED IN ORDER TO**
13 **DETERMINE THE AMOUNTS OF AUSF SUPPORT FOR AN**
14 **INDIVIDUAL LEC?**

15 A. Qwest proposes that before a carrier is eligible to draw money from the AUSF it
16 should "first be required to make a showing, either through a R14-2-103 filing, or

⁹⁹ For example, section 14 of the Frontier Citizens Utilities Rural local tariff (*Telephone Service Tariff*) explains that if cost of construction of line extensions exceeds "normal conditions," the end-user will pay actual construction cost in excess of "normal" level. Specifically, at p. 2 it says as follows: "Under normal conditions, the Company, without charge, will extend its lines to reach applicants provided that the cost of constructing the required line extension will not exceed seven times the estimated annual exchange revenue from such applicant or applicants. ... If the line extension requirements of an applicant or group of applicants exceed the above, a construction charge will be made for the facilities in excess of the allowances specified above." It further explains on p. 3 that "[i]n those circumstances where extensions to outside plant facilities exceed the allowance in 14.1.2.a) above [seven times the estimated annual exchange revenue], the customer, in addition to any material or labor to be furnished by him, will pay in advance the estimated total cost of the Company's construction as prescribed in a contract executed between the Company and the customer."

1 through a simplified earnings review, that their earnings do not exceed the
2 authorized rate of return.”¹⁰⁰ The Joint CLECs support this proposal. Only if the
3 ILEC exhausts all avenues of end-user rate increases, and the revenue is still
4 insufficient to generate allowable rates of return, should the carrier be given
5 AUSF support. Further, the amount of support determined from a rate proceeding
6 or earnings review should not be guaranteed to the carrier indefinitely because
7 technological advances, population shifts, introduction of new
8 telecommunications products or other changes may eliminate the need for support
9 in the future. Because the carrier/recipient of AUSF would have no incentive to
10 disclose the fact that it no longer needs support, the Commissions should develop
11 procedures that require recipient carriers to periodically update the data in the rate
12 case that demonstrated the need for AUSF support.

13 **Q. PLEASE SUMMARIZE ISSUES 7 THROUGH 10.**

14 A. The fund should *not be a replacement* for loss of access revenue stemming from
15 the reduction in access rates. Funding should be based on public interest need and
16 limited to cases of high cost and low income support. Line extensions should not
17 be funded to the extent the cost of their construction is recovered through the
18 “special constructions” tariff provisions. In order to receive funding, a carrier
19 should show the need. Before a carrier is allowed to draw from the AUSF, there
20 should be a demonstration of need. The carrier-recipient of the fund should also

¹⁰⁰ Qwest Corporation’s Reply Regarding Matrix Issues and Procedural Recommendations, October 7, 2008, p. 2.

1 be required to periodically refresh the data used to justify support in order to
2 demonstrate to the Commission that it continues to need AUSF support.

3
4 **Issue 11. What should be the basis of AUSF contributions and what should be the**
5 **structure of any AUSF surcharge(s)?**
6

7 **Q. WHAT SHOULD BE THE BASIS OF AUSF CONTRIBUTIONS?**

8 A. Qwest notes that funding “should come from all sectors of the industry, i.e. ILEC,
9 CLEC, Cable, Wireless and VOIP providers...”¹⁰¹ The CLECs agree with this
10 proposal. The CLECs disagree with Qwest’s proposal calling for the Arizona
11 Commission to automatically follow the FCC, should the FCC changes its method
12 to fund the federal USF.¹⁰² Specifically, AT&T’s and Verizon’s federal advocacy
13 is to move USF contribution to a numbers based system. Since IXC operations
14 typically do not have many, if any, telephone numbers, this proposal essentially
15 excludes IXC operations doing business in Arizona from contributing to the
16 AUSF. Instead, the Commission should carefully consider changes enacted by
17 the FCC to assure that customers are not assessed twice for USF contributions
18 (State and Federal) on the same revenue.¹⁰³

¹⁰¹ *Qwest Corporation’s Reply Regarding Matrix Issues and Procedural Recommendations*, October 7, 2008, p. 4.

¹⁰² See *Qwest Corporation’s Reply Regarding Matrix Issues and Procedural Recommendations*, October 7, 2008, p. 4; *Issues Matrix Arizona Local Exchange Carriers Association*, October 7, 2008, p. 5; *AT&T’s Issues Matrix and Procedural Recommendations*, October 7, 2008, p. 5; and *Verizon’s List of Issues*, October 7, 2008, p. 4

¹⁰³ *McLeodUSA’s Statement on Issues*, October 7, 2008, p. 4.

1 IXC's pay intrastate switched access today in order to originate and terminate long
2 distance calls made by IXC customers. Creating a fund based on all carriers
3 intrastate revenues has the effect of requiring all carriers in the state, even those
4 that do not do business in the areas receiving access-related funding, to subsidize
5 IXC's customers. In other words, where previously IXC's such as AT&T and
6 Verizon paid rural carriers when AT&T and Verizon's customers made toll calls
7 to rural areas, they now propose that CLECs contribute to an access revenue
8 recovery fund for the benefit of AT&T's and Verizon's customers to originate and
9 terminate calls to rural ILECs. The Joint CLECs find this problematic unless
10 there is a clear showing that the AUSF is for the purpose of *universal service*
11 (rather than a pure benefit of IXC's), and carriers drawing from the fund have
12 demonstrated need as proposed by Qwest.

13
14 **Issue 12. Any other specific revisions to the AUSF rules.**

15 **Q. DO THE JOINT CLECS HAVE ANY PROPOSED REVISIONS TO AUSF**
16 **RULES AT THIS TIME?**

17 **A.** No.

18
19 **Q. DOES THIS CONCLUDE YOUR TESTIMONY?**

20 **A.** Yes.

BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS

**KRISTIN K. MAYES, Chairman
GARY PIERCE
PAUL NEWMAN
SANDRA D. KENNEDY
BOB STUMP**

**IN THE MATTER OF THE REVIEW AND
POSSIBLE REVISION OF ARIZONA
UNIVERSAL SERVICE FUND RULES,
ARTICLE 12 OF THE ARIZONA
ADMINISTRATIVE CODE.**

DOCKET NO. RT-00000H-97-0137

**IN THE MATTER OF THE
INVESTIGATION OF THE COST OF
TELECOMMUNICATIONS
ACCESS.**

DOCKET NO. T-00000D-00-0672

REPLY TESTIMONY

OF

DOUGLAS DENNEY

ON BEHALF OF

**Eschelon Telecom of Arizona, Inc.; Mountain Telecommunications, Inc.; Electric
Lightwave, LLC; McLeodUSA Telecommunications Services, Inc. d/b/a PAETEC Business
Services; tw telecom of arizona llc; and XO Communications Services, Inc.**

PUBLIC VERSION

February 5, 2010

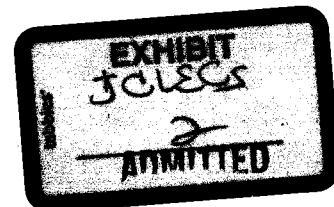


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1 **I. INTRODUCTION**

2 **Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.**

3 A. My name is Douglas Denney. I work at 1201 NE Lloyd Boulevard, Suite 500,
4 Portland, Oregon.

5 **Q. ARE YOU THE SAME DOUGLAS DENNEY WHO PREVIOUSLY FILED**
6 **TESTIMONY IN THIS PROCEEDING?**

7 A. Yes, I filed direct testimony on December 1, 2009.

8 **Q. DO YOU HAVE ANY CORRECTIONS TO YOUR DIRECT**
9 **TESTIMONY?**

10 A. Yes. When comparing competitive local exchange carrier ("CLEC") access rates
11 to Qwest's access rates in 1999, I omitted one of Qwest's rate elements
12 (interconnection charge of \$0.006/minute), meaning that the last row in Table 1
13 on p. 19 of my direct testimony, which contains Qwest's composite access rates
14 labeled "Qwest Pre-Price Cap," should be revised upwards: The originating rate
15 should be \$0.03424 (instead of \$0.02803), and the terminating rate should
16 \$0.04844 (instead of \$0.04223). This correction does not affect other numbers in
17 this table. A corrected Table 1 is presented below.

Table 1: Corrected

Table 1: Originating and Terminating Access Rate Comparison

LEC	Originating	Terminating	Source Intrastate Tariff
AT&T LEC	\$ 0.02803	\$ 0.04223	AT&T Communications of the Mountain States Access Services and Network Interconnection Services Price List
Verizon LEC	\$ 0.05027	\$ 0.07115	MCImetro Access Transmission, Tariff No. 2
Average AT&T and VZ	\$ 0.03915	\$ 0.05669	
Integra:			
ELI	\$ 0.02990	\$ 0.04270	Switched Exchange Access Telecom Services Tariff No. 3
Eschelon	\$ 0.02967	\$ 0.05241	Access Service Tariff No. 2
Mountain	\$ 0.02967	\$ 0.05241	Telecommunications Tariff No. 1
McLeodUSA	\$ 0.05523	\$ 0.05523	Intrastate Access Tariff No. 4
tw telecom	\$ 0.03610	\$ 0.04409	Intrastate Telecommunications Access Services Tariff No. 4
XO	\$ 0.03434	\$ 0.04854	Access Service Tariff No. 7
Average JCLECs	\$ 0.03582	\$ 0.04923	
Qwest Pre-Price Cap	\$ 0.03424	\$ 0.04844	See note below

Current tariffs can be found on the ACC web site: <http://www.azcc.gov/Divisions/Utilities/Tariff/util-tariffs-telecom.asp>. Qwest's historical access rates are based on Docket No. T-01051B-99-0105 (1999 Price Cap Docket), Testimony of Barbara M. Wilcox on behalf of Qwest, January 8, 1999, Exhibit BMG-5.

Q. WHAT IS THE PURPOSE OF THIS TESTIMONY?

A. The purpose of this testimony is to respond to selected issues raised in direct testimonies of other parties as they relate to the issues and positions of the Joint

1 CLECs as outlined in my direct testimony. Like my direct testimony, this
2 testimony is organized by issue as they were outlined in the procedural order.¹

3 **Q. PLEASE SUMMARIZE YOUR TESTIMONY.**

4 A. No party has demonstrated that Joint CLEC access rates are unjust or/and
5 unreasonable or above cost. The mere desire by interexchange carriers ("IXCs")
6 to avoid paying to use local exchange carrier ("LEC") networks is not justification
7 to reduce intrastate access rates in Arizona. Parties that point to interstate access
8 rates as the alleged evidence that intrastate rates should be reduced do not make
9 an "apples-to-apples" comparison because that fails to account for the difference
10 in the *structure* of the two rate schemes: (interstate switched access charges
11 include the federal Subscriber Line Charge ("SLC"), a rate element not instituted
12 by the state of Arizona. Staff's witness, Mr. Shand, recognizes this difference.
13 When SLC is factored in, the federal composite interstate access rate (rate applied
14 to Qwest and CLECs) is approximately 3.57 cents per minute, which is higher
15 than Qwest's intrastate access rate in Arizona.²

16 Further, the issue of whether rates of specific carriers/groups of carriers are
17 "unreasonable" or/and "below cost" should be considered separately from the
18 issue of "from whom should the cost be recovered" (end-users or IXCs). Because
19 IXCs use networks of local exchange carriers to the benefit of IXCs and IXC end-

¹ *Procedural Order*, September 29, 2009, pp. 4-5.

² This is discussed in detail with respect to, "Issue 2. To what target level should access rates be reduced?"

1 users, it is unfair to shift the burden of the network cost to LECs and LEC end-
2 users.

3 In my direct testimony I summarized five proposals from the Joint CLECs. Joint
4 CLECs first recommended that the Commission address rural ILEC access rates
5 before addressing CLEC access rates.³ Both Rural LECs ("RLECs") and IXC
6 apparently agree that RLEC access rates should be addressed. The process by
7 which this is accomplished is complex and disagreements remain as to the best
8 method to achieve access reductions for rural carriers. The Commission would be
9 best served by focusing its efforts first on rural ILEC access rates.

10 Second, the Joint CLECs recommended that to the extent the Commission elects
11 to implement an arbitrary benchmark (i.e. a benchmark other than cost) for CLEC
12 access rates, the Commission should benchmark the CLEC rates to the 1999
13 Qwest access rates.⁴ These were the rates in place in Arizona before Qwest
14 entered into a number of voluntary access rate reductions which were contingent
15 on complete revenue neutrality for Qwest. (For example, under the original Price
16 Cap Plan, the revenues available to Qwest under the Cap for Basket 3 Services
17 were increased by \$5 million each year that access was reduced.) These
18 negotiated Qwest reductions did not include any discussion of CLEC access rates
19 and, likewise, did not include any sort of mechanism for CLECs to recover access
20 revenue had the reductions applied to CLECs. Based upon the direct testimony

³ Denney Direct, pp. 6-7.

⁴ Denney Direct, pp. 7-8.

1 filed in this case, the Joint CLECs would further recommend, to the extent the
2 Commission decides to reduce CLEC access rates at this time, the Commission
3 should limit these reductions to terminating access rates. Parties seeking
4 reductions in CLEC access rates focus their arguments on the CLECs' asserted
5 monopoly with regard to terminating access. This CLEC "monopoly" argument
6 is not supported by the parties with respect to originating access⁵ and thus any
7 benchmarking of CLEC access rates should be limited to terminating rates.⁶

8 The Joint CLEC's third recommendation focused on timing. To the extent the
9 Commission elects to reduce CLEC access rates at this time, reductions should be
10 phased in gradually to give CLECs ample opportunity to adjust business plans
11 and update term contracts. The Joint CLECs proposed a 3 year period before
12 reductions are implemented and then a gradual phase in over five to seven years
13 for the actual reductions.⁷ A number of parties in this proceeding recommend that
14 CLEC rates be benchmarked to Qwest's current intrastate or interstate access
15 rates. While the Joint CLECs do not believe this is appropriate, the Joint CLECs
16 do note that Qwest had a period of approximately 6 years to phase in and adjust to
17 its current intrastate access rates. To the extent the Commission does not approve
18 the transition recommended by the Joint CLECs, the Commission should, at a

⁵ AT&T witness Dr. Oyefusi is the only witness to argue LECs have a monopoly with respect to originating access. As demonstrated in this testimony his conclusion is incorrect.

⁶ This is discussed in more detail under the heading, "Issue 1. What carriers should be covered by access reform?"

⁷ Denney Direct, pp. 8-10.

1 minimum allow Joint CLECs the same amount of time that was provided to

2 Qwest to phase in access rate reductions.⁸

3 Fourth, the Joint CLECs recommended that AUSF funds only be distributed after
4 a demonstration of need, and contributions to the fund be derived from all
5 providers of telecommunications services.⁹

6 Finally, the Joint CLECs recommended that to the extent the Commission
7 addressed CLEC access issues, it should also address the appropriate rate for
8 intraLATA, intraMTA calls terminated by wireless providers to LECs.¹⁰

9 **II. ISSUES POSED BY THE PROCEDURAL ORDER**

10
11 **Issue 1. What carriers should be covered by access reform?**

12
13 **To The Extent the Commission Mandates Access Rates Reductions for Joint**
14 **CLECs, these Reductions Should be Limited to Terminating Access Rates**

8 This is discussed in more detail under the heading, "Issue 3. What procedures should the Commission implement to achieve the desired reduction in access rates?"

9 Denney Direct, pp. 10-12.

10 Denney Direct, p. 12. This is also discussed in more detail under the heading, "Issue 1. What carriers should be covered by access reform?"

1 **Q. MR. SHAND TAKES A POSITION THAT IXCS HAVE NO CHOICE**
2 **WHEN TERMINATING CALLS AND THEREFORE, "THE**
3 **TERMINATING ACCESS RATE FOR CLECS SHOULD BE CAPPED AT**
4 **THE INCUMBENT LECS RATES."**¹¹ **PLEASE RESPOND.**

5 A. It is significant that Mr. Shand's reasoning leads only to a proposal to cap
6 CLECs' *terminating* access rates. Indeed, talks about the alleged monopoly
7 power of access providers typically revolve around the observation that a
8 *terminating* IXC does not have any (immediate) options but to *terminate* a call to
9 the LEC, and ignore the originating access. For example, Mr. Shand's only
10 discussion about the alleged market power in the access market consists of one
11 phrase: "With respect to *termination* of a call to a CLECs' customers, the IXCs
12 have no alternative but to pay the CLECs' rates to terminate calls."¹² Mr. Shand
13 goes on to cite several passages from the FCC *CLEC Access Charge Order*,¹³
14 none of which discuss market power in originating access.¹⁴ Yet, Mr. Shand
15 presents his overall recommendation for CLEC access rates, which calls for
16 capping CLECs access rate generally, with no distinction made between
17 originating and terminating access.¹⁵

¹¹ Direct Testimony of Wilfred Shand of behalf of Utilities Division, ACC ("Shand Direct"), p. 9.

¹² Shand Direct, p. 10 (emphasis added).

¹³ *In the Matter of Access Charge Reform*, Seventh Report and Order and Further Notice of Proposed Rulemaking, CC Docket No. 96-262; FCC 01-146, April 27, 2001 ("*CLEC Access Charge Order*").

¹⁴ Shand Direct, pp. 10-11.

¹⁵ Shand Direct, p. 11.

1 **Q. WHY SHOULD ORIGINATING ACCESS BE DISCUSSED SEPARATELY**
2 **FROM TERMINATING ACCESS?**

3 A. IXC's argument that CLECs have monopoly power over terminating access is
4 based on the claim that IXCs have no alternative when terminating a call to a LEC
5 customer.¹⁶ However, this argument makes no sense in the context of originating
6 access. Originating access applies when the LEC end user has chosen the IXC as
7 its long distance provider. Because the customer of the LEC is necessarily also
8 the customer of the IXC (this is not necessarily the case for terminating access)
9 the IXC has the ability to set long distance prices for its customer by taking into
10 account originating access. Since end user customers look at their total
11 telecommunications cost when selecting a local carrier, if a LEC were to set
12 originating access charges too high it risks losing its customer as the customer
13 would seek a carrier that can provide a better overall pricing for its
14 telecommunications needs.

15 **Q. WHAT ARGUMENTS FOR CAPPING CLECS ACCESS RATES ARE**
16 **CONTAINED IN MR. SHAND'S CITATIONS FROM THE FCC *CLECS***
17 ***ACCESS CHARGE ORDER*?**

18 A. These citations¹⁷ contain three substantive arguments: that (1) it is an anomaly for
19 a "competitive" provider to enter a market by charging well in excess of the

¹⁶ See, for example, Oyefusi Direct, p. 23.

¹⁷ Shand Direct, pp. 10-11. I do not include in this list "non-substantive" arguments, by which I mean declaratory statement that rates are unjust and unreasonable, or that CLECs have a monopoly power.

1 access rate charged by the market's incumbent; (2) high access charges allow
2 CLECs unfairly to shift their operational expenses and their network build-out
3 expenses to IXC's; and (3) CLECs access rates are unilaterally imposed through
4 tariffs, rather than through negotiation with a willing purchaser.

5 The first argument does not apply to the Joint CLECs in Arizona, because, as I
6 also demonstrated in Table 1 of my direct testimony,¹⁸ access rates for CLECs in
7 this case are similar to the rates that existed for Qwest in 1999 – the approximate
8 time frame of CLECs entry. My analysis suggests that CLECs in this case, when
9 entering the local markets, set their access rates at the level of the incumbent (a
10 strategy that is reverse to the “anomaly” that concerned the FCC in its *CLEC*
11 *Access Charge Order*). As I noted in my direct testimony,¹⁹ changes to Qwest's
12 rates since 1999 were the result of a series of revenue neutral settlement
13 agreements entered into by Qwest for Qwest's benefit. There is no justification to
14 apply reductions agreed to by Qwest to Qwest's competitors. This is tantamount
15 to allowing the CLECs largest competitor to directly set the CLECs rates in the
16 market.

17 Because the first argument (charging rates well in excess of the incumbent at the
18 time of competitive entry) does not apply to the Arizona situation, the second
19 argument – that it is unfair to use high access cost to shift network built-out

¹⁸ Denney Direct, p. 19. This table was corrected in my reply testimony (see Table 1: Corrected). As explained the correction did not change any of the conclusions based on this table.

¹⁹ Denney Direct, p. 49.

1 expense to IXC – does not apply either. As noted by Dr. Johnson, the opposite
2 may be the case: “[M]any of the carriers participating in this proceeding view the
3 basic local exchange customer as the “cash cow” that should be forced to cover
4 most of the fixed costs of the network, while other services ... like wireless
5 carrier interconnection service and interstate switched access service – are being
6 priced at very low levels (near zero), due to the success of their advocacy efforts
7 before the FCC.”²⁰

8 The third argument – that CLECs access rates are imposed “unilaterally” through
9 a tariff rather than through negotiations with a willing purchaser – is similarly
10 weak. If CLECs *had* sufficient power to unilaterally impose any access rate, their
11 access rates would likely have been much higher. There must be some constraints
12 that prevented the Joint CLECs from setting their intrastate access rates at the
13 levels of Arizona RLECs, which are significantly higher. For example, CLECs
14 could have set their access rates at the level of Arizona RLECs. Based on Mr.
15 Shand’s exhibit WMS-1, Southwestern has a composite terminating access rate of
16 27.8 cents a minute, SCUTA – 21.5 cents, Frontier/White Mountain – 16.7 cents,
17 Midvale – 14.7 cents and etc. In contrast, the Joint CLECs’ composite
18 terminating access rates are in the vicinity of 4 to 5 cents.²¹

²⁰ Direct Testimony of Ben Johnson on behalf of RUCO (“Johnson Direct”), p. 21.

²¹ Denney Direct, p. 19 Table 1.

1 **Q. DO OTHER PARTIES SIMILARLY ACKNOWLEDGE THAT ALLEGED**
2 **MARKET POWER IN THE ACCESS MARKET IS LIMITED TO**
3 **TERMINATING ACCESS?**

4 A. Yes. For example, Ms. Eckert's (Qwest) language is very specific to *terminating*
5 access. She addresses the issue of the alleged "bottleneck" qualities of access
6 services on pp. 5 and 9. In both cases she justifies her claims by discussing only
7 *termination* (and not origination) of long-distance calls. Similarly, Mr. Appleby
8 (Sprint) justifies his statement that switched access is a "monopoly" service by
9 explaining that "[a]ll carriers that compete against LECs in the retail market must
10 use switched access to *terminate* non-local calls to the LECs' customers."²² Mr.
11 Meredith (ALECA)²³ does not address market power in switched access. Mr.
12 Price (Verizon), while claiming that an IXC does not have a choice when
13 originating or terminating a call, nevertheless emphasizes the terminating side by
14 stating that CLECs possess market power "*particularly as relates to terminating*
15 *switched access service*"²⁴ and references an academic publication for "a
16 discussion of *terminating* access monopoly"²⁵ without providing a parallel
17 reference to a source that would discuss *originating* access "monopoly." Based
18 on my review, Dr. Oyefusi (AT&T) is the only witness who argues that an IXC

²² Direct Testimony of James A. Appleby on behalf of Sprint ("Appleby Direct"), p. 4 (emphasis added).

²³ Direct Testimony of Douglas Duncan Meredith on behalf of ALECA ("Meredith Direct").

²⁴ Direct Testimony of Don Price on behalf of Verizon ("Price Direct"), p. 8.

²⁵ Price Direct, p. 11 footnote 5 (emphasis added).

1 does not have a choice when terminating or originating a call,²⁶ but even he
2 recognizes that CLEC rates are constrained when he states, "If left on their own,
3 the CLECs have an incentive to increase access rates as much as they can."²⁷
4 Given that the Joint CLEC intrastate access rates are significantly below the
5 intrastate access rates of other LECs in Arizona, it is clear that CLECs do not
6 have the market power to *increase rates as much as they can*.

7 **Q. IS IT REALLY IMPORTANT THAT AN IXC DOES NOT HAVE A**
8 **CHOICE OF AN ACCESS PROVIDER WHEN IT TERMINATES OR**
9 **ORIGINATES A CALL?**

10 A. No, it is not very important that an IXC does not have a choice *at the very*
11 *instance* of the call. (Arguably, when such extreme short run is concerned, many
12 real life situations appear to be "no choice" situations.²⁸) A more important
13 question is whether an IXC has an ability to control its access cost in medium and
14 long-run – the framework more appropriate for "market power" analysis. The
15 answer to this question is "yes."

16 Parties in this case shy away from claiming monopoly power in originating access
17 because the IXC's control over originating cost in the medium and long-run is
18 particularly apparent: For example, for decades IXCs have been using "special

²⁶ Direct Testimony of Ola Oyefusi on behalf of AT&T (Oyefusi Direct), p. 23.

²⁷ Oyefusi Direct, p. 30.

²⁸ For example, if lost in a desert in a foreign country, my only choice may be to call for help via my AT&T Wireless phone – thus incurring international roaming charges of many dollars per minute. Yet, this lack of choice at the very instance of the call is not sufficient grounds to claim that AT&T Wireless has an "originating monopoly" in the foreign country.

1 access by-pass” (use of special access facilities to connect large end-users to long-
2 distance networks) to avoid switched access charges.

3 More recently, since local exchange markets became open to competition, and
4 large LECs “blended” with IXCs,²⁹ bundling local and long-distance service
5 introduced a method of controlling switched access cost associated with end users
6 of all sized and segments (not just large business customers): Currently, the most
7 direct way for an IXC to control its access cost is to acquire the end-user as a
8 local customer (thus, serving the end-user as both a LEC and an IXC). This is
9 particularly effective in the CLECs markets: Most of the CLECs focus on
10 business markets, where customer acquisition is typically pro-active: CLEC’s sale
11 representative calls potential end-users. Because LECs proactively pursue
12 potential business customers, it is easy for a company such as AT&T (an IXC and
13 CLEC) to selectively target business customers that are served by a LEC with
14 relatively high switched access rates. If the LEC’s access rates are really
15 excessive in relation to the true cost of providing access, AT&T (as an example)
16 should be able to offer the end-user a local and long-distance package that would
17 bring access cost savings to AT&T. The higher the access rates of the LEC that
18 originally serves the end-user, the higher competition for this end-user from
19 competing providers of bundled local/long-distance services. In other words,
20 when setting its access rates, the LEC recognizes that the danger of setting rates at

²⁹ In the sense that RBOCs entered the in-region interLATA long-distance markets and largest IXCs were bought by largest ILECs.

1 high levels is the higher risk of losing the end-user to competitors. As a result,
2 competition for end-users acts as a constraint on switched access rates.

3 **Q. DID THE FCC CLEC ACCESS CHARGE ORDER ACKNOWLEDGE THE**
4 **SCENARIO IN WHICH AN IXC CONTROLS ITS ACCESS COST BY**
5 **COMPETING FOR THE END USER IN THE LOCAL MARKET?**

6 **A.** Yes. The FCC CLEC Access Charge Order said as follows:

7 The Commission previously projected that, at least in the case of
8 originating access service, IXCs would likely enter marketing alliances
9 with LECs offering low-priced access service and would thereby be able
10 to exert downward pressure on CLEC access rates. The Commission even
11 raised the prospect that IXCs would themselves choose to enter the local
12 service market as a means of exerting downward pressure on terminating
13 rates. However, *neither of these eventualities has come to pass*, at least not
14 to an extent that has resulted in effective downward competitive pressure
15 on CLEC access rates.³⁰

16 Recall that the above cited text dates back to April 2001 – the time frame that
17 predates the mega-mergers between RBOCs and largest IXCs. As I noted in my
18 direct testimony,³¹ both of these “eventualities” previously projected by the FCC
19 *have come to pass* as the IXC and LEC segments of the industry are now
20 “blended” together.

21 **Q. DO TECHNOLOGICAL DEVELOPMENTS PROVIDE ADDITIONAL**
22 **MEANS FOR AN IXC TO CONTROL ITS ORIGINATING AND**
23 **TERMINATING ACCESS COST?**

³⁰ CLEC Access Charge Reform Order, ¶ 32 (footnote omitted; emphasis added).

³¹ Denney Direct, p. 38.

1 A. Yes. Dr. Oyefusi brings up one such development, which is VoIP technology.
2 Dr. Oyefusi claims that interconnected VoIP providers such as Vonage (VoIP
3 service that allow calls to and from public switched network) pay as little as
4 \$0.0007 per minute to complete calls.³² Dr. Oyefusi fails to mention that AT&T
5 itself for years has been using VoIP services to cut its interconnection cost. For
6 example, AT&T (the IXC) introduced residential VoIP service similar to
7 Vonage's service (AT&T CallVantage®) in 2004 – the year it also announced its
8 withdrawal from stand alone consumer (residential) long-distance market.³³
9 While Internet news blogs reported that AT&T stopped offering AT&T
10 CallVantage® service to new customers in 2008-2009 time frame,³⁴ AT&T is
11 currently offering various other VoIP services to both residential and business
12 customers.³⁵

³² Oyefusi Direct, pp. 18-19.

³³ See AT&T Form 10-K for 2004: "On July 22, 2004 we announced that ... we would no longer be investing to actively acquire new mass market local and stand-alone long distance customers." The same 10-K form also discusses the FCC orders surrounding intercarrier compensation for VoIP traffic, including the FCC ruling against a petition AT&T filed in October 2002, "holding that our long distance phone-to-phone IP telephony services are subject to terminating access charges.... As a result of this ruling, we will begin paying terminating access charges on our long distance phone-to-phone IP telephony calls." Regarding the FCC ruling that services such as Vonage services fall within the interstate jurisdiction, AT&T's 2004 10-K form concludes that "[o]ur newer VoIP services fall within this description and as a result will be subject predominantly to FCC rules."

³⁴ See, for example, <http://gigaom.com/2008/07/03/att-shuts-callvantage/>. Indeed, the current version of AT&T CallVantage web site (<https://www.callvantage.att.com/>) appears to cater only to existing customers.

³⁵ See AT&T "VoIP" page (<http://www.corp.att.com/voip/>), which offers "High speed Voice over IP service for your home or business." It does not appear that AT&T offers these products in Arizona.

1 **Q. DR. OYEFUSI ARGUES FOR MANDATORY REDUCTIONS TO CLECS**
2 **ACCESS RATES ON THE GROUNDS THAT UNDER FEDERAL LAW**
3 **IXCS CANNOT CHARGE GEOGRAPHICALLY DE-AVERAGED TOLL**
4 **RATES.³⁶ PLEASE RESPOND.**

5 A. First, Dr. Oyefusi admits that this federal regulation concerns interstate toll rates,
6 and that on the intrastate side IXCs offer geographically averaged rates “as a
7 practical matter... to enable uniformity in billing.”³⁷ In other words, IXCs charge
8 uniform intrastate toll rate to cut their own billing cost.

9 Second, Dr. Oyefusi does not see the double standard in his argument: The
10 prohibition of geographic de-averaging of toll rates has been implemented to
11 serve the public interest at large; apparently, the lawmakers found it appropriate
12 to spread the burden of varying long-distance and access cost across all
13 participants in the market. By contrast, the policies advocated by AT&T seek to
14 have CLECs alone shoulder the burden by denying them adequate compensation
15 for switched access services rendered.

16 Third, while Dr. Oyefusi complains that (the geographically averaged) AT&T toll
17 prices in Arizona are lower than access rates of “some” Arizona LECs,³⁸ he fails
18 to acknowledge that this result is a direct consequence of the geographically

³⁶ Oyefusi Direct, pp. 21 and 23.

³⁷ Oyefusi Direct, p. 21 footnote 11.

³⁸ Oyefusi Direct, p. 27.

1 averaged rate design.³⁹ When a toll price is set based on *average* cost, some data
2 points that compose this average would be above, but others would be *below* the
3 toll price. Indeed, if AT&T statewide toll price were set to cover access cost
4 associated with *all* LECs, including LECs with the highest access rates, AT&T
5 would be collecting abnormal profits from calls associated with “average” and
6 “below average” LECs.

7
8 **The Commission Should Also Establish the Terminating Rate for Intrastate,**
9 **IntraMTA Wireless Calls**

10
11 **Q. AT&T COMPLAINS ABOUT “TREMENDOUS DISPARITIES”⁴⁰ IN**
12 **INTERCARRIER COMPENSATION RATES PAID BY WIRELINE**
13 **CARRIERS VERSUS WIRELESS CARRIERS THAT CREATE**
14 **“COMPETITIVE ADVANTAGE FOR WIRELESS LONG DISTANCE**
15 **SERVICES.”⁴¹ PLEASE COMMENT.**

16 **A.** While the disparities definitely exist, AT&T’s testimony fails to recognize that
17 AT&T is likely the biggest beneficiary of this disparity as one of the two largest

³⁹ This result is also related to the fact that access costs constitute a large portion of overall toll cost.

⁴⁰ Aron Direct, p. 71.

⁴¹ *Id.*

1 wireless carriers in the country.⁴² Yet, I agree that this is a serious problem given
2 the size of wireless industry: According to the FCC data, there are over 4.9
3 million wireless subscribers in Arizona,⁴³ and only 3.1 million wireline access
4 lines⁴⁴ (including Qwest, other ILECs and CLECs). I estimate from the FCC
5 minutes of use data that intrastate wireless traffic in Arizona is approximately 32
6 billion minutes a year,⁴⁵ while intrastate (non-local) traffic for nonQwest ILECs
7 and CLECs is approximately 1.4 billion minutes a year.⁴⁶ Dr. Aron observed that
8 the majority of the state belongs to the same Major Trading Area ("MTA"),⁴⁷

⁴² According to the most recent FCC report on Wireless Competition (*13th Report* in WT Docket No. 08-27 released on January 16, 2009 "*FCC 2009 Wireless Competition report*", p. 7 chart 1), AT&T was the largest wireless company nationwide with over 70 million subscribers followed by Verizon Wireless with 65 million subscribers (data for 2007). However, this ranking will likely be reversed in the more recent reports that would account for the merger between Verizon and Alltel (closed in 2009). According to the above mentioned FCC report, Alltel had over 13 million subscribers in 2007).

⁴³ *FCC Local Telephone Competition Report* released July 2009, Table 14 (data as of June 2008). The exact number is 4,935,640.

⁴⁴ *Id.*, Table 7 (data as of June 2008).

⁴⁵ Calculated as the number of Arizona wireless subscribers (4,935,640; from the *FCC Local Telephone Competition Report* released in July 2009, Table 14) times average wireless minutes per month (769 minutes; nationwide data for the second half of 2007 from the *FCC 2009 Wireless Competition report*, p. 7) times 12 months times percent of intrastate minutes in wireless total minutes (71%; nationwide data for residential calling in 2007 from the *FCC Trends in Telephone Service Report* released in August 2008, Table 11.4).

⁴⁶ Calculated by using annual state (non-local) Dial Equipment Minutes ("DEMs") in 2000 (the most recent year when DEM data was reported; data available at <http://www.fcc.gov/wcb/iatd/neca.html>, "Network Usage by Carrier") and CLECs Arizona current line counts. Specifically, total minutes is the sum of DEMs for all Arizona ILECs other than Qwest in 2000 (488,129,559) plus CLECs intrastate (non-local) minutes calculated as follows: Arizona CLECs access lines (1,128,827; data for June 2008 from the *FCC Local Telephone Competition Report*, Table 7) times Qwest's Arizona state DEMs in 2000 (2,331,630,000) divided by Qwest's Arizona USF loops in 2000 (2,932,088; NECA data available at <http://www.fcc.gov/wcb/iatd/neca.html>, "Universal Service Fund Data: NECA Study Results").

⁴⁷ Aron Direct, p. 41 (see also map of Arizona MTAs on p 43).

1 meaning that the majority of the wireless intrastate traffic (32 billion a year) is
2 subject to reciprocal compensation rates.⁴⁸

3 **Q. HOW ARE WIRELESS INTRAMTA RECIPROCAL COMPENSATION**
4 **RATES DETERMINED?**

5 A. While the Commission has jurisdiction over these rates,⁴⁹ it is my understanding
6 that the Commission has not addressed these rates in a systematic fashion.⁵⁰
7 These rates are typically set in bilateral interconnection agreements between
8 wireless and landline carriers – *if* there is an interconnection agreement, which is
9 not always the case. Unfortunately, wireless carriers have refused to negotiate an
10 agreement, in which case the exchange of traffic is not compensated. Integra has
11 faced difficulty negotiating contracts with certain wireless carriers. This issue
12 likely affects not only Integra, but other CLECs and ILECs in Arizona. As noted
13 above, wireless market is significantly bigger than wireline market, and the traffic
14 is not in balance, meaning that a “bill and keep” arrangement does not provide
15 fair compensation to a wireline carrier.

16 A local exchange company cannot refuse to terminate wireless traffic. Therefore,
17 in order to get fair compensation for terminated traffic its only option is to litigate
18 the case. Litigation is costly and inefficient not only for litigating carriers, but
19 also for the Commission (given the potential number of pairs “LEC-wireless

⁴⁸ Aron Direct, p. 73 and Appleby Direct, p. 8.

⁴⁹ See my direct testimony, Denney Direct, p. 22.

⁵⁰ The Commission set reciprocal compensation rates for Qwest in cost docket No. T-00000A-00-0194. These rates would apply in situations involving termination to Qwest end users.

1 carrier"). Therefore, it makes sense for the Commission to set default termination
2 rates for wireless intraMTA traffic. Because the Joint CLECs propose that if the
3 Commission mandates CLECs access rate reductions, these reductions should be
4 based on cost,⁵¹ it is only logical that the Joint CLECs default rates for intraMTA
5 traffic termination be set at the same (cost-based) switched access level. Under
6 this design the rate for intraMTA traffic would be the same as the rate for
7 terminating intrastate switched access traffic, meaning that the "playfield" would
8 be leveled for wireless and wireless long-distance services.

9 **Q. PLEASE SUMMARIZE YOUR TESTIMONY ON INTRAMTA**
10 **WIRELESS TRAFFIC.**

11 A. Wireless intraMTA traffic in Arizona is by an order of a magnitude larger than
12 intrastate switched access traffic of ILECs and CLECs taken together. If the
13 Commission wishes to "create a level playing field for all companies in
14 Arizona"⁵² and/or address the "competitive advantages of wireless long distance
15 services,"⁵³ the Commission should do so by tackling the five hundred pound
16 gorilla in the room – rates for intraMTA wireless termination over which it has
17 jurisdiction. The Commission should clarify that local exchange carriers are
18 entitled for compensation for intraMTA traffic from wireless carriers, and set
19 default compensation rates.

⁵¹ Denney Direct, p. 8.

⁵² Eckert Direct, p. 7.

⁵³ Aron Direct, p. 71.

Issue 2. To what target level should access rates be reduced?

Any Target Other Than The Carrier Cost is Arbitrary

Q. HAS ANY PARTY PRESENTED ACTUAL EVIDENCE THAT CLEC ACCESS RATES ARE EXCESSIVE?

A. No, there has been no substantive evidence presented in this proceeding that CLEC access rates are excessive or are not just and reasonable. The only “evidence” that parties typically cite (without regard to a particular group of carriers) are the generic complaints that intrastate access rates are higher than interstate rates.⁵⁴ However, as correctly noted by Staff’s Mr. Shand, “[i]nterstate access charges are generally lower than intrastate access charges because of the manner in which costs that have been allocated to interstate access are recovered.”⁵⁵ Here Mr. Shand refers to the monthly federal Subscriber Line Charge (“SLC”) that the FCC instituted to recover certain interstate access cost (often referred to as “non-traffic-sensitive” cost) – a charge that is collected from an end-user, rather than an IXC. Currently, Qwest’s federal SLC in Arizona is \$6.20 per line per month.⁵⁶ When combined with Qwest’s Arizona total interstate access volumes and access lines, this SLC translates into a 2.6 cents charge per

⁵⁴ Aron Direct, p. 83. Oyefusi Direct, pp. 18-19.,

⁵⁵ Shand Direct, p. 4.

⁵⁶ Qwest’s Tariff FCC No. 1, section 4.7.1.

1 minute.⁵⁷ In other words, because the state access rate structure is different from
2 the interstate rate structure, to properly compare Qwest's interstate and intrastate
3 access rates, 2.6 cents per minute should be added to the interstate rate.
4 Incidentally, because Qwest's composite intrastate access rate is believed to be
5 around 2.22 cents,⁵⁸ it follows that Qwest's composite interstate access rate (when
6 recalculated on a per minute basis) is higher than its intrastate rate.

7 **Q. TO CLARIFY YOUR LAST POINT: IF QWEST'S INTERSTATE SLC**
8 **SWITCHED ACCESS RATE IS CONVERTED TO A PER MINUTE**
9 **BASIS, WHAT WOULD BE QWEST'S COMPOSITE INTERSTATE**
10 **ACCESS RATE?**

11 **A.** According to the FCC, Qwest's composite interstate access rate without SLC is
12 0.99 cent per minute, which includes both traffic sensitive (per minute) and non-
13 traffic sensitive (per month) charges other than SLC.⁵⁹ When SLC (2.6 cents per
14 minute) is added to this number, Qwest's total composite interstate switched
15 access rate on a per minute basis is **3.57 cents**.

⁵⁷ Calculated as \$6.20 divided by Interstate Access Minutes per Month per Line (which is Total Annual Interstate Access Minutes (5,422,374,736) divided by USF Loops (1,910,999) divided by 12 months, resulting in 240 minutes per month per line). Minutes and USF Loops data are for 2008 contained in NECA submissions and available at <http://www.fcc.gov/wcb/iatd/neca.html>, "Network Usage by Carrier" and "Universal Service Fund Data: NECA Study Results."

⁵⁸ Shand Direct, p. 19.

⁵⁹ Source: the FCC 2009 Monitoring Report, Table 7.10, data for Qwest's 14-state territory, rates effective between July 2009 and June 2010. Traffic sensitive portion is 0.79 cents, and non-traffic sensitive portion is 0.20 cents per minute. Note that the resulting aggregate rate (0.99 cents per minute = 0.79 + 0.20) is consistent with AT&T estimates for Qwest Arizona contained in highly confidential Figure 1 of Aron Direct, p. 10.

1 **Q. SHOULD THE COMMISSION ALTER THE INTRASTATE ACCESS**
2 **RATE STRUCTURE TO INSTITUTE A PER LINE PER MONTH**
3 **CHARGE SIMILAR TO THE FEDERAL SLC?**

4 A. No. Just because the FCC instituted this manner of cost recovery does not mean
5 that the Commission should follow suit. As correctly noted by Dr. Johnson,⁶⁰ the
6 majority of non-traffic sensitive cost is what he calls “joint cost” – cost of
7 facilities shared by several services. Dr. Johnson discusses local loop as a typical
8 example of a “joint cost” facility – facility that is used by both local and toll
9 service.⁶¹ He concludes that “[i]t makes no economic sense to impose the entire
10 cost of the access line, as part of the price of local service, on the particular end
11 user who requests installation of the line. Rather, it is appropriate to recover the
12 cost from all of the beneficiaries of that line--including the other local customers
13 in that city and the toll carriers that also benefit from the new line....”⁶² In other
14 words, just like my direct testimony,⁶³ Dr. Johnson expresses an opinion that
15 IXCs/toll services should pay for the use of local loop that makes their services
16 possible.

⁶⁰ Johnson Direct, pp. 26-28.

⁶¹ *Id.*, pp. 27-28.

⁶² *Id.*, p. 28.

⁶³ Denney Direct, pp. 61-63.

1 Further, as I explained in my direct testimony,⁶⁴ current interstate rates were not
2 established based on cost, but were a result of negotiations where concessions on
3 unrelated issues were traded for access reductions.

4 **Q. DR. OYEFUSI CLAIMS THAT INTERSTATE RATES ARE GREATER**
5 **THAN COST BECAUSE THE FCC'S COST BASED RATE IS \$0.0007.⁶⁵**
6 **IS THIS CORRECT?**

7 A. No. The \$0.0007 referred to by Dr. Oyefusi came out of the FCC's ISP Remand
8 Order.⁶⁶ The rate established by the FCC was not for interstate access traffic, but
9 dial up ISP traffic⁶⁷ and was not based on a cost study, but instead based upon a
10 rates agreed to by Level 3 as part of agreements with AT&T.⁶⁸ Further, the FCC
11 recognized that carriers cost to deliver ISP traffic may exceed the \$0.0007 rate⁶⁹
12 and specifically found "These rates do not, therefore, reflect the costs incurred by
13 any particular carrier for providing service to a particular customer."⁷⁰

⁶⁴ Denney Direct, pp. 31-33.

⁶⁵ Oyefusi Direct, p. 44.

⁶⁶ In the Matter of Implementation of the local Competition Provisions in the Telecommunications Act of 1996 and Intercarrier Compensation for ISP-Bound Traffic, CC Docket No. 96-98 and CC Docket No. 99-68, Order on Remand and Report and Order ("ISP Remand Order"), released April 27, 2001.

⁶⁷ *ISP Remand Order*, ¶ 1.

⁶⁸ *ISP Remand Order*, ¶ 85.

⁶⁹ *ISP Remand Order*, ¶ 80.

⁷⁰ *ISP Remand Order*, ¶ 77.

1 **Q. DR. ARON REFERS TO RECIPROCAL COMPENSATION RATES AS**
2 **“EVIDENCE” THAT INTRASTATE SWITCHED ACCESS RATES ARE**
3 **TOO HIGH.⁷¹ PLEASE RESPOND.**

4 A. Reciprocal compensation is not a good “benchmark” for CLECs and RLECs
5 access rates for a number of reasons. First, reciprocal compensation involves
6 two-way/mutual exchange of local traffic between two local exchange carriers.
7 If the traffic is in balance, it does not matter whether the reciprocal compensation
8 is zero or, as an example, 30 cents per minute. Because the exchange is directed
9 both ways, often carriers agree to low or zero (bill and keep) rates. In contrast,
10 switched access involves “one-way” exchange in the sense that an IXC (an
11 intermediary) is using networks of two local exchange carriers. In the case of
12 reciprocal compensation for local traffic there is no intermediary carrier and
13 therefore, as an example, there is no need to allocate the cost of local loop
14 between “local” and “access” services (because only local service/local carrier
15 uses the loop during local call).

16 Further, reciprocal compensation is not a good “benchmark” for access rates
17 because there may be cost differences between the provision of local call
18 termination and access services. For example, from Qwest’s UNE cost models
19 we know that Qwest uses different traffic measurement/billing systems (with

⁷¹ Aron Direct, p. 83.

1 different per minute cost) for access and local traffic.⁷² Other factors that drive
2 cost differences between access and local traffic include call duration and trunk
3 utilization. Finally, while Qwest's reciprocal compensation rates were indeed
4 established based on an investigation of its cost, these rates have nothing to do
5 with the cost incurred by *other* carriers (CLECs and RLECs) in Arizona.

6 **Q. YOUR DIRECT TESTIMONY SUGGESTED THAT IF THE**
7 **COMMISSION DECIDES TO REVIEW CLECS ACCESS RATES, THE**
8 **STANDARD FOR THIS REVIEW SHOULD BE EACH CLEC'S COST.**
9 **DO ANY PARTIES PROVIDE TESTIMONY IN SUPPORT FOR THE**
10 **NOTION THAT COST IS THE MOST APPROPRIATE STANDARD?**

11 **A.** Yes. Mr. Shand proposes that CLECs have an option of filing a cost study if they
12 believe their cost is higher than the ILEC's cost (at which rates CLECs would be
13 capped under Mr. Shand's proposal).⁷³ Dr. Aron justifies AT&T proposal of
14 reducing intrastate rates to the level of interstate rates by saying that this proposal
15 would bring intrastate rates closer to cost.⁷⁴ Ms. Eckert (Qwest) provides
16 examples of states that cap CLECs access rates.⁷⁵ As seen from Ms. Eckert's
17 citations to state rules,⁷⁶ Connecticut, New York and Pennsylvania rules include
18 such cost justification of higher rates. Similarly, California rules also allow

⁷² See, for example, the ongoing Colorado docket No. 07A-211T, Qwest's March 4, 2009 filing, Direct Testimony of Christopher Viveros on behalf of Qwest, Exhibit CV-9, which contains Qwest's local interconnection usage (reciprocal compensation) study.

⁷³ Shand Direct, p. 11.

⁷⁴ Aron Direct, pp. 82-83.

⁷⁵ Eckert Direct, pp. 8-9.

⁷⁶ Eckert Direct, pp. 8-9.

1 CLECs to justify rates in excess of the established benchmark (which is 10% over
2 the higher of SBC or Verizon's rates) by using the CLEC's actual cost.⁷⁷
3 According to Mr. Price,⁷⁸ Nebraska is another example of a state that, while
4 regulating CLECs access rates, also permits them to charge cost-justified rates.
5 While it is not captured in Mr. Price's citations to state rules, Massachusetts
6 (which is on Mr. Price's list of states that cap CLECs access rates) also allows
7 exemption from the cap on CLEC access rates based on a cost showing.⁷⁹ In
8 general, regulators' efforts to reform intercarrier compensation rates have been
9 aimed at bringing rates closer to cost (not further from cost). For example, just
10 last month the FCC Commissioner Clyburn said "Intercarrier compensation
11 reform should include harmonizing interstate and intrastate interconnection rates,
12 and those rates should be just and reasonable and *reflect the actual costs to use*
13 *the networks.*"⁸⁰

⁷⁷ See California Public Utilities Commission Decision 07-12-020 in Rulemaking 03-08-018 dated December 6, 2007, 2007 Cal. PUC LEXIS 609, *24: "The Commission may authorize intrastate access charges higher than these caps upon a showing, supported by a detailed cost-of-service study, that a competitive carrier's actual costs exceed the caps adopted in today's decision."

⁷⁸ Price Direct, p. 16.

⁷⁹ See Massachusetts Department of Telecommunications and Cable, D.T.C. 07-9 Order On Motion For Reconsideration And Clarification dated December 7, 2009, p. 21: "a CLEC will be subject to the rate cap (once effective) unless and until the Department determines, based on a cost filing, that it is reasonable for the CLEC to charge switched access rates above the rate cap."

⁸⁰ See Prepared Remarks of FCC Commissioner Mignon L. Clyburn, OPASTCO's Winter Meeting, San Diego, CA, January 25, 2010 (emphasis added).

1 **Q. HAS VERIZON ARGUED THAT ACCESS RATE REDUCTIONS NOT**
2 **BASED ON A CARRIER'S COST ARE CONFISCATORY AND THUS**
3 **ILLEGAL?**

4 A. Yes. Verizon recently filed for a stay of the New Jersey Board of Public Utilities
5 decision to "dramatically reduce [Verizon's] access charges."⁸¹ Verizon argues
6 that a LEC must be permitted to "recover the costs it incurs to provide [regulated]
7 services, along with a constitutionally adequate return of and on investments
8 needing to provide such services."⁸² Verizon argues that a regulator cannot look
9 to services in an unregulated, competitive market in order to "ensure that those
10 services produce a sufficient return to make up for any shortfall from the services
11 the regulator does control."⁸³ In other words, Verizon is saying that it would be
12 inappropriate for a commission to set CLEC access rates below cost and expect
13 CLECs to pass those rate reductions onto its customers in the competitive retail
14 market. A copy of Verizon's request is attached to this testimony as exhibit DD-
15 1.

⁸¹ In the Matter of the Board's Investigation and Review of Local Exchange Carrier Intrastate Exchange Access rates, BPU Docket No. TX08090830, Emergent Application for a Stay of the Board's Access Charge Order, ("Verizon Stay Request"), February 3, 2010, p. 1.

⁸² *Verizon Stay Request*, p. 1.

⁸³ *Verizon Stay Request*, p. 4.

If Cost is Not Used to Set Access Rates, then for CLECs Competing in the Qwest Territory, Qwest's 1999 Access Rates Should be Used

Q. YOUR DIRECT TESTIMONY PROPOSED THAT IF THE COMMISSION ELECTS TO ESTABLISH A BENCHMARK FOR CLEC ACCESS RATES OTHER THAN COST, THE BENCHMARK SHOULD BE QWEST'S INTRASTATE ACCESS RATE FOR 1999. DID OTHER PARTIES' DIRECT TESTIMONY CONTAIN ANY SUPPORT FOR THIS PROPOSAL?

A. Yes. Dr. Aron, when discussing the FCC 2001 *CLEC Access Charge Order* that capped CLECs interstate access rates, provides the following citation from ¶ 37 of this order:

[The FCC found] persuasive the IXC arguments that it is highly unusual for a competitor to enter a market at a price dramatically above the price charged by the incumbent, absent a differentiated service offering.⁸⁴

The significance of the above citation is that the argument that persuaded the FCC was focusing on price differentials between the incumbent and competitive carriers *at the moment of entry*. This citation is consistent with my proposal to use Qwest's 1999 intrastate switched access rates as a benchmark for CLEC rates: As I explained,⁸⁵ the 1999 time frame was the time period when most CLECs were

⁸⁴ Aron Direct, p. 87.

⁸⁵ Denney Direct, p. 49.

1 entering the competitive market. These rates would have been considered when
2 CLECs made the determination on whether they could enter and compete in local
3 markets. Further, the Qwest access rates in 1999 time reflected the price Qwest
4 thought it needed to charge for access, before buying down that price with a
5 subsidy from revenue earned from other services (Basket 3 services). The
6 changes which followed to Qwest's access rates were the result of a series of
7 revenue neutral settlement agreements entered into by Qwest for Qwest's benefit
8 – changes that CLECs cannot (on the revenue side) mimic. I also noted that most
9 CLECs have rates that are similar to the rates that existed for Qwest in 1999.⁸⁶

10
11 **Issue 3. What procedures should the Commission implement to achieve the**
12 **desired reduction in access rates?**

13
14 **Reduction in Access Rates Should be Implemented Gradually to Allow LECs**
15 **Adequate Opportunity to Adjust Their Business Plans**

16
17 **Q. YOUR DIRECT TESTIMONY PROPOSED THAT IF THE COMMISSION**
18 **DECIDES TO MANDATE ACCESS RATE REDUCTIONS FOR CLECS,**
19 **THE TRANSITION PERIOD SHOULD BE AT LEAST 8 TO 10 YEARS.⁸⁷**
20 **DO ANY PARTIES ADDRESS THE DANGERS OF SUDDEN CHANGES**
21 **IN RATES AND COST SHIFTING?**

⁸⁶ Denney Direct, p. 49.

⁸⁷ Denney Direct, p. 13.

1 A. Yes. Dr. Johnson comments on the dangers of sudden rate changes throughout
2 his testimony. For example, Dr. Johnson states, “the arguments in favor of drastic
3 cost shifting tend to be inconsistent with both economic theory and common
4 sense.”⁸⁸ Dr. Johnson addresses the issues of sudden rate changes as harmful to
5 competition by noting as follows: “it is also important to carefully evaluate the
6 potential consequences of proposed realignments of telecommunications prices at
7 this stage in the effort to transition toward a more competitive market. While
8 reducing access rates may benefit some carriers, the policy changes being
9 advocated in this case won't necessarily help new entrants gain a foothold in the
10 market, and there may be unintended consequences of such a policy, which may
11 make further progress towards effective competition less likely to be achieve in
12 some markets.”⁸⁹

13 **Q. THE PARTIES GENERALLY PRESUME THAT CLECS CAN INCREASE**
14 **THEIR END-USER PRICES TO COMPENSATE FOR MANDATED**
15 **ACCESS RATE REDUCTIONS.⁹⁰ IS IT AN ACCURATE PRESUMPTION**
16 **IN ARIZONA?**

17 A. No. First, as I noted in my direct testimony, CLECs are small carriers (when
18 compared to Qwest, their incumbent competitor) operating in competitive end-

⁸⁸ Johnson Direct, p. 8.

⁸⁹ Johnson Direct, p. 25.

⁹⁰ For example, Mr. Price (Verizon) claims on p. 4 that “CLECs already have unfettered retail pricing flexibility because they are not subject to rate regulation and may price their retail services as they wish.”

1 user markets, and therefore, are *price takers in the end-user markets*.⁹¹ As such,
2 CLECs cannot simply offset ordered access rate reductions by a “revenue neutral”
3 increase in their end-user local rates because their biggest competitor, Qwest,
4 would not be subject to access rate reductions and therefore, would not be
5 increasing local rates. Competitive markets mean that all carriers (CLECs and the
6 ILEC, Qwest) charge essentially the same “market rate.” If the current market
7 rate for local business line is \$25 per line per month (as an example), but
8 tomorrow the Commission mandates CLECs access rate reductions, CLECs
9 would not be able to compensate lost access revenues through higher local rates:
10 A CLEC cannot charge a rate of \$30 per line per month because its end-users
11 would simply migrate to Qwest (who continues to offer the rate of \$25 per line
12 per month). Dr. Oyefusi recognizes this when he testifies, “CLECs did not and do
13 not have market power in retail local services...”⁹²

14 Second, I also explained in my direct testimony that CLECs serve primary
15 business markets and typically have long-term contracts with their business
16 customers.⁹³ Because the prices that CLECs charge end-users are typically fixed
17 for the term of the end-user agreement, CLECs may not be able to immediately
18 increase end-user prices for existing term customers to compensate for lost access
19 revenue.

⁹¹ Denney Direct, p. 9. I am stressing here “end-user market” to clarify that the issue of the alleged market power in the access markets is not important here.

⁹² Oyefusi Direct, p. 23.

⁹³ Denney Direct, p. 52.

1 Third, contrary to the claims of Mr. Price that "CLECs already have unfettered
2 retail pricing flexibility because they are not subject to rate regulation and may
3 price their retail services as they wish,"⁹⁴ Arizona-specific rules do not allow
4 CLECs to simply increase their end-user rates as they wish. Instead, CLECs end-
5 user services are tariffed, and the rates are subject to maximum ceilings contained
6 in these tariffs.⁹⁵ In order to increase the maximum ceiling, a CLEC would have
7 to obtain permission from the Commission. Before the CLEC can file the
8 application to obtain this permission, it must notify customers of the planned rate
9 increase. In other words, even if the Commission permits to increase in
10 maximum rates, obtaining the permission will take time given that the
11 Commission may request additional information, and could schedule a hearing on
12 the rate increase.⁹⁶

13 **Q. WHAT WAS THE LENGTH OF THE TRANSITION PERIOD IN**
14 **QWEST'S INTRASTATE ACCESS RATE REFORM?**

15 **A.** Qwest had a period of approximately six years to reduce intrastate access rates to
16 their current levels. Over this time period Qwest made four reductions in
17 intrastate access rates.

⁹⁴ Price Direct, p. 4.

⁹⁵ See Arizona Rule R14-2-1109.

⁹⁶ See Arizona Rule R14-2-1110.

1 During the 1999 price cap docket⁹⁷ Qwest entered into a settlement in October
2 2000 to reduce intrastate access rates. This settlement was approved on March
3 30, 2001 and rate reductions took place in three equal steps over a three year
4 period beginning April 1, 2001.⁹⁸ Qwest agreed to further access reductions as
5 part of a settlement in the 2003 price cap docket.⁹⁹ This settlement was filed in
6 August 2005 and the Commission approved the settlement on March 23, 2006.
7 Access rate reductions took effect on April 1, 2006. If the Commission decides
8 to mandate CLECs access rate reductions, the transition period applicable to
9 CLECs should be no shorter than Qwest's transition period.

10
11 **Issue 4. Should carriers be permitted to contract for access rates that differ from**
12 **their tariffed rates?**

13
14 **Carriers Should be Required to Pay Tariff Access Rates**
15
16
17
18

⁹⁷ In the Matter of the Application of U S WEST Communications, Inc. for a Hearing to Determine the Earnings of the Company for Ratemaking Purposes, to fix a Just and Reasonable Rate of Return thereon and to Approve Rate Schedules, Docket No. T-01051B-99-0105, Opinion and Order, ("1999 Price Cap Order"), March 30, 2001.

⁹⁸ Qwest was able to make revenue-neutral rate increases to offset the access reductions. See Denney Direct, pp. 20-21.

⁹⁹ In the Matter of Qwest Corporation's Filing of Renewed Price Regulation Plan, Docket No. T-01051B-03-0454, Opinion and Order, ("2003 Price Cap Order"), March 23, 2006.

1 **Q. MR. SHAND PROPOSES TO ALLOW CONTRACTS BETWEEN CLECS**
2 **AND IXCS THAT CONTAIN LOWER THAN TARIFFED ACCESS**
3 **RATES. MR. SHAND PROPOSES THAT THESE CONTRACTS ARE**
4 **FILED WITH THE COMMISSION AND BE AVAILABLE TO**
5 **SIMILARLY SITUATED CARRIERS.¹⁰⁰ PLEASE RESPOND.**

6 **A.** First, the Commission should clarify that IXCs are required to pay tariffed access
7 rates. The Commission must affirm that IXCs are prohibited from engaging in self
8 help (*i.e.*, withholding payments for access charges based on filed rates) as a
9 means of forcing a CLEC to “agree” to reduce rates for that IXC. Second, LECs
10 should be allowed to enter into contracts for rates that differ from the tariffed
11 rates. Further, the Joint CLECs are not opposed to Mr. Shand’s proposed
12 requirement that contracts containing rates that differ from tariffed rates be filed
13 with the Commission.

14 **Issue 6. How much of access cost recovery, if any, should be shifted to end users?**
15 **What showing should be required for such a shift? What should be the**
16 **role of “benchmark” rates and how should benchmarks be set?**

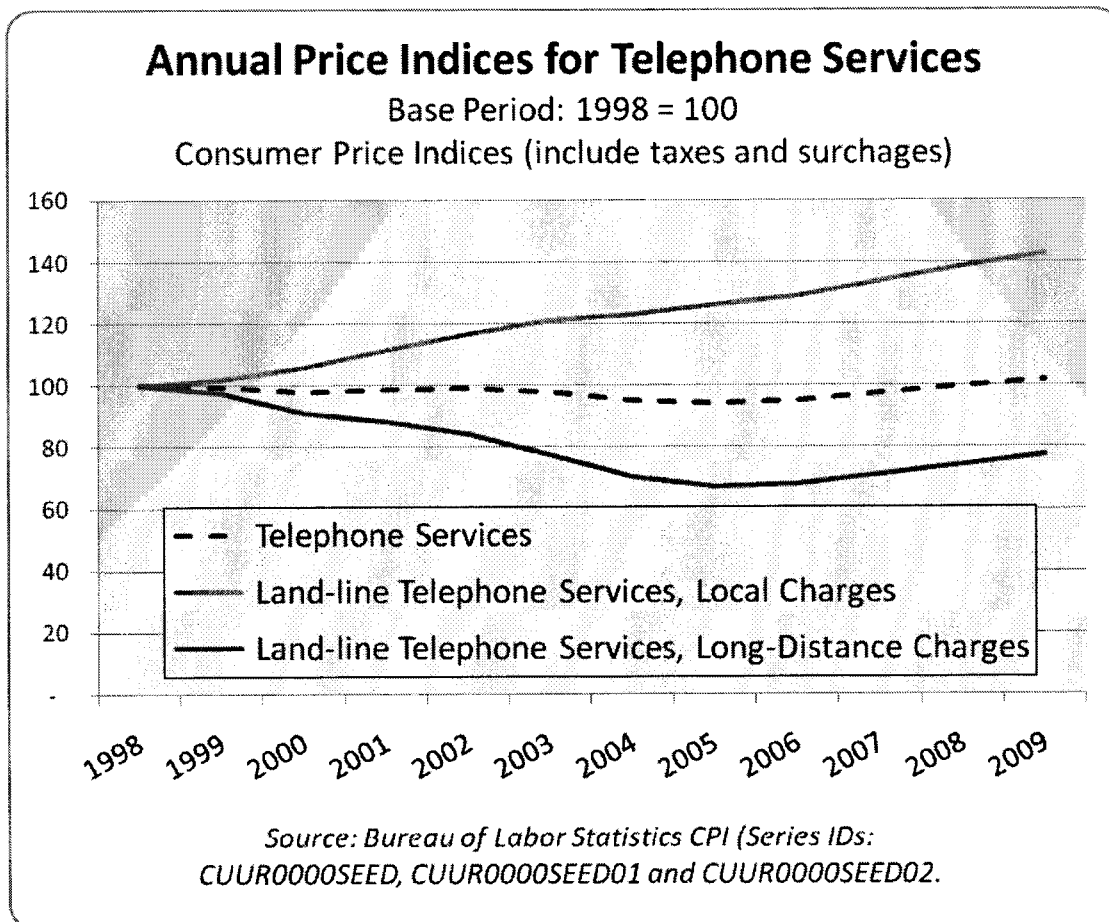
17
18 **AT&T Projections of the Alleged End User Savings from Access Rate Reductions**
19 **are Overstated**

¹⁰⁰ Shand Direct, pp. 3-4.

1 **Q. DR. ARON PRESENTS VARIOUS DATA¹⁰¹ INTENDED TO CONVINCE**
2 **THE COMMISSION THAT ACCESS RATE REDUCTIONS WOULD**
3 **NECESSARILY TRANSLATE INTO LOWER TOLL PRICES AND**
4 **SAVINGS TO END USERS. PLEASE COMMENT.**

5 A. While I do not dispute that there is a correlation between access rates and toll
6 prices, I do not agree that this correlation would necessarily bring savings to
7 Arizona end users. There are a number of flaws in Dr. Aron's analysis that result
8 in a misleadingly optimistic picture of consumer benefits from the envisioned
9 access reductions. First of all, Dr. Aron's analysis neglects to account for
10 **increases in local service charges and USF surcharges** that would be necessary
11 to replace lost access revenue. If historical changes in toll prices are looked at
12 next to historical changes in local rates and surcharges, it becomes clear that the
13 two are part of a "zero-sum game." The following chart, which depicts Consumer
14 Price Indices ("CPIs") of Local and Long-Distance telephone service nationwide,
15 as well as telephone service in aggregate, makes this point:

¹⁰¹ Aron Direct pp. 55 – 67.



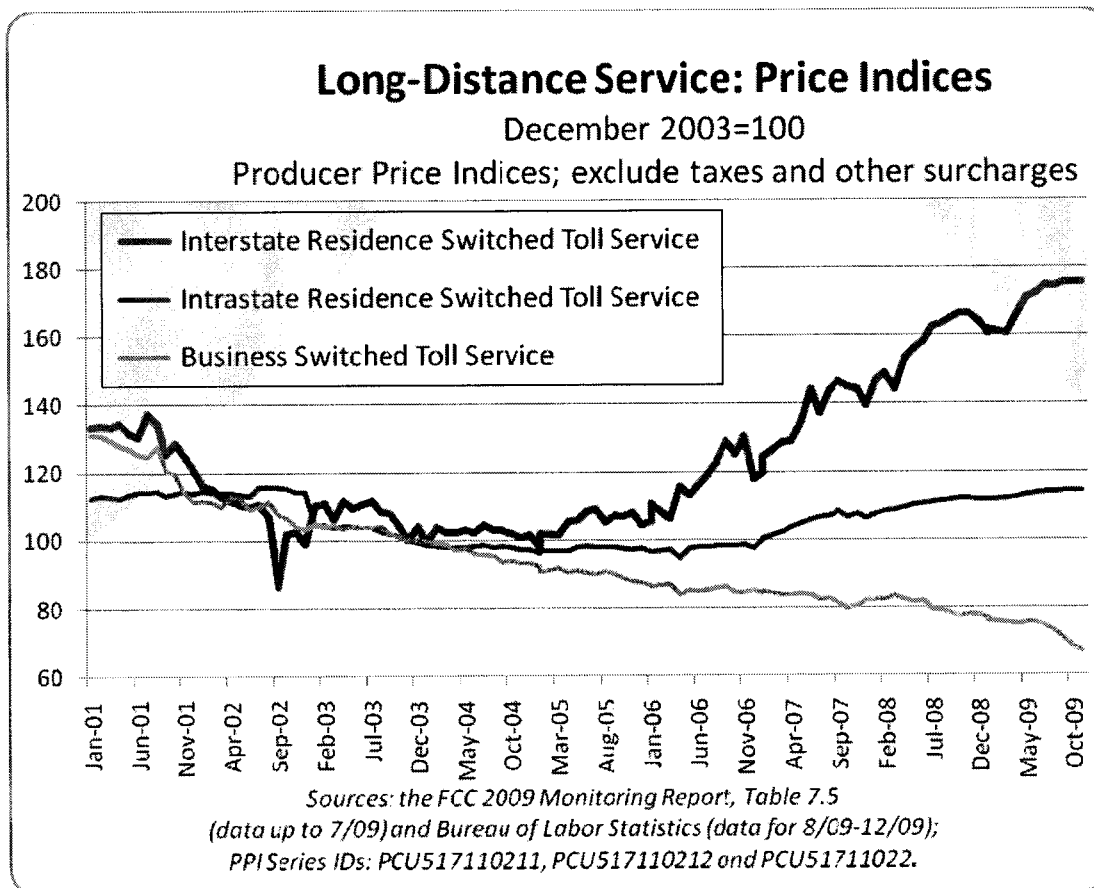
As shown in the above chart, while toll prices have been falling in the last ten years, local service prices have been increasing, and the price index of “aggregate” telephone service was relatively stable. Therefore, while access rate reductions may bring savings to *long-distance* customers, local customers (many

1 of which would not be the same as long-distance customers) would see increases
2 in their local service expenditures.¹⁰²

3 The second flaw in Dr. Aron's analysis is that she does not separate residential
4 markets from business markets. Recent price trends in residential and business
5 markets have been quite different (despite the fact that the same access rates apply
6 to business and residential calls), as can be seen from the toll price index data
7 collected by the U.S. Bureau of Labor Statistics ("BLS").¹⁰³ These data are
8 presented in the following chart:

¹⁰² Dr. Aron attempts to address this issue on pp. 97-98 of her testimony by citing an old academic paper that examined the dynamics of telephone penetration rates, local and toll prices between 1984 and 1990. According to Dr. Aron, this paper found that "rate rebalancing" (between toll and local prices) resulted in increased telephone penetration during the period studied (1984-1990). While this result may indeed have been *suggested by* the old data, its relevance to current markets is highly questionable because of the drastic changes in toll prices that happened since that time. Specifically, based on the FCC data (the FCC 2008 *Trends in Telephone Service Report*, Table 13.4), while current (2006) Average Revenue per Minute ("ARPM") for interstate and international calls is around 7 cents, it was 30 cents in 1984 (when measured in then-current dollars; this is equivalent to 63 cents a minute when measured in 2006 dollars) and 20 cents in 1990 (or, equivalently, 31 cents in 2006 dollars). It is unreasonable to draw parallels between one market where a price dropped from 63 to 31 cents a minute and another market where the initial price is only 7 cents.

¹⁰³ Here I use the BLS's Producer Price Indices ("PPIs") rather than Consumer Price Indices because the former exclude taxes and surcharges, and as such, present a more appropriate measure of "raw" toll prices.



As captured in the chart above, interstate residential toll prices increased between the end of 2003 (the “baseline” period in the BLS data for which the index is set to 100) and present by almost 1.8 times.¹⁰⁴ Yet, as shown in Dr. Aron’s Figure 5 on page 59,¹⁰⁵ interstate access rates have been roughly at the same level since

¹⁰⁴ The index for December 2009 is 175.6, which, as all BLS price indices, is a preliminary measure subject to revisions four months after its initial publication. The most recent “non-preliminary” index is for August 2009, which is 174.9.

¹⁰⁵ As a side note, there must be an error in Dr. Aron’s chart. Dr. Aron’s chart shows that the interstate long-distance price (Average Revenue per Minute (“ARPM”)) dropped in 2006. However, a review of the referenced source of the data on this chart (Table 13.4 of the FCC 2008 *Trends Report*) shows that this data point is incorrect, and the ARPM in 2006 should be at the same level as the ARPM in 2005 (\$0.06). Further, the more recent FCC *Monitoring Report* for 2009, Table 7.6 contains the ARPM data on interstate calls for 2007, which is \$0.07 per minute.

1 2003. Clearly, the dramatic increases in interstate residential toll prices between
2 2003 and present cannot be explained by changes in interstate access rates.

3 Further, the above chart shows that while intrastate residential toll prices also
4 increased, rates for business toll service have been falling. Therefore, combining
5 residential and business toll markets into one measure (as done in Dr. Aron's
6 analyses) would create a misleading appearance of relatively stable¹⁰⁶ toll rates.

7 The distinction between residential and business toll market is important because
8 of the different levels of competitive pressures (incentive to decrease price) that
9 exist in these markets. Arguably, competition in residential markets in Arizona is
10 significantly smaller than competition in business markets.¹⁰⁷ Weaker
11 competitive pressures mean that long-distance carriers have fewer incentives to
12 pass through their access cost savings to residential end-users.

13 The third flaw in Dr. Aron's analysis is that her regression-based projections of
14 alleged consumer savings (19 to 42%¹⁰⁸) do not account for the manner in which
15 AT&T sets its long-distance pricing. As I noted in my direct testimony,¹⁰⁹ in
16 residential markets AT&T offers the *same* in-state calling plans in different states

¹⁰⁶ Current price index for the combined business and residential toll service is only 110, or, equivalently, 1.1 times higher than this index at the end of 2003 (see BLS Index for "Public Switched Toll Service", series ID PCU5171102, data for December 2009). This result is due to the fact that business segment of toll market is larger than the residential segment.

¹⁰⁷ According to the FCC 2008 *Trends Report*, Table 9.6, in 2007 (the most recent data available), Qwest dominated the long-distance residential market in the West (its 14-state serving territory) with 46.9% share in intraLATA direct-dialed minutes and 53.8% share in direct-dialed interLATA minutes. AT&T share in both segments was 2.2 and 2.1% correspondingly.

¹⁰⁸ Aron Direct, p. 65.

¹⁰⁹ Denney Direct, pp. 64-65.

1 (such as the “10 cents a minute plan with a \$2.99 monthly fee”¹¹⁰), with the only
2 difference between states being an “in-state connectivity fee,” which is currently
3 \$1.49 per month in Arizona. Therefore, unless AT&T abandons its practice of
4 uniform (across states) pricing, Arizona’s residential consumers can at most
5 expect an elimination of the in-state connectivity fee (\$1.49 per month).
6 However, this maximum savings is the *upper boundary* and is likely too
7 optimistic because, as I noted in my direct testimony, even in “low access cost”
8 states such as Nebraska AT&T has the in-state connectivity fee, and this fee in
9 Nebraska is even higher than the Arizona in-state connectivity fee.¹¹¹

10 **Q. DO YOU HAVE ANY OTHER COMMENTS ABOUT DR. ARON’S**
11 **FORECAST OF ARIZONA TOLL PRICE REDUCTIONS STEMMING**
12 **FROM AT&T PROPOSED ACCESS RATE REDUCTIONS?**

13 A. Yes. Dr. Aron makes this forecast based on the nationwide data of intrastate toll
14 and access rates depicted in her Highly Confidential Figure 6.¹¹² Dr. Aron
15 provided the underlying data for Figure 6 in response to Joint CLEC Discovery
16 Request 1.1.¹¹³ This data set – while appropriate in an academic study, is too
17 broad for the specific purpose of this case (evaluating proposals to reduce access
18 rates) as it includes a large number of observations for which intrastate access

¹¹⁰ See AT&T web site at <http://www.shop.att.com/plancomparison.jsp>.

¹¹¹ *Id.*

¹¹² Aron Direct, p. 61.

¹¹³ This data set contains annual observations for 50 states between 2004 and 2008. Dr. Aron’s regression model assumes that access cost affect toll rates with a lag of one year. As a result, Dr. Aron’s regression data set contains in a total of 200 observations (=50 states times four years of data).

1 costs are significantly higher than Arizona access rates. Much more appropriate
2 for this case is the examination of data points that correspond to “low” access
3 rates. Specifically, because AT&T’s proposal is to set Arizona intrastate rates at
4 interstate rates,¹¹⁴ Dr. Aron’s analysis should have focused on data points that
5 approximate AT&T’s proposal. Based on Dr. Aron’s Highly Confidential Figure
6 7,¹¹⁵ AT&T interstate per minute access cost in Arizona is slightly under
7 ***BEGIN HIGHLY CONFIDENTIAL [REDACTED] END HIGHLY
8 CONFIDENTIAL***. Examination of Dr. Aron’s intrastate toll and access rates
9 data underlying her Highly Confidential Figure 6 shows that currently¹¹⁶
10 ***BEGIN HIGHLY CONFIDENTIAL [REDACTED] END HIGHLY
11 CONFIDENTIAL*** intrastate access rates¹¹⁷ as low as AT&T’s proposal.
12 Further, while there ***BEGIN HIGHLY CONFIDENTIAL [REDACTED]
13 [REDACTED] END HIGHLY CONFIDENTIAL***
14 out of 200 observations in Dr. Aron’s data set for which intrastate access cost is
15 below the AT&T proposal for Arizona, toll rates that correspond to ***BEGIN
16 HIGHLY CONFIDENTIAL [REDACTED]

¹¹⁴ Oyefusi Direct, p. 4.

¹¹⁵ Aron Direct, p. 63.

¹¹⁶ Here “currently” means the most recent data point in Dr. Aron’s data set, which is year 2008.

¹¹⁷ Here “intrastate rates” mean AT&T average intrastate access cost contained in the data underlying Figure 6 that was provided in response to Joint CLEC Discovery Request 1.1.

1 **END HIGHLY CONFIDENTIAL***** are not that different from Arizona toll
2 rates, especially when considering the difference in access costs.¹¹⁸

3 **Q. A NUMBER OF PARTIES, INCLUDING STAFF,¹¹⁹ VERIZON¹²⁰ AND**
4 **ALECA¹²¹ PROPOSE THAT ALL INTRASTATE ACCESS RATES BE**
5 **SET TO OR CAPPED AT QWEST'S INTRASTATE ACCESS RATES.**
6 **CAN YOU EVALUATE THIS PROPOSAL BASED ON DR. ARON'S**
7 **NATIONWIDE INTRASTATE TOLL AND ACCESS RATE DATA THAT**
8 **UNDERLY HER FIGURE 6?**

9 **A. Yes. Qwest's composite intrastate access rate in Arizona is believed to be**
10 **\$0.022.¹²² Based on Dr. Aron's data set of nationwide access and toll rates, there**
11 **are ***BEGIN HIGHLY CONFIDENTIAL ■ END HIGHLY**
12 **CONFIDENTIAL*** observations (out of 200) with intrastate access rates at or**
13 **below Qwest's Arizona intrastate access rates. The average intrastate toll price**
14 **that correspond to these observations is ***BEGIN HIGHLY**
15 **CONFIDENTIAL ■■■■■ END HIGHLY CONFIDENTIAL***, which is**
16 **very close to Arizona's current intrastate toll price of ***BEGIN HIGHLY**
17 **CONFIDENTIAL ■■■■■ END HIGHLY CONFIDENTIAL***. In other**

¹¹⁸ Toll rates were as follows: *****BEGIN HIGHLY CONFIDENTIAL** ■■■■■
■■■■■ **END HIGHLY CONFIDENTIAL*****. Year 2008 is the most
recent data point.

¹¹⁹ Shand Direct, p. 26.

¹²⁰ Price Direct, p. 3.

¹²¹ Meredith Direct, p. 7.

¹²² Shand Direct, p. 19.

1 words, while there are states with intrastate access rates that are capped as low as
2 Qwest's Arizona intrastate access rates, intrastate toll prices in these states are on
3 average the *same* as intrastate toll prices in Arizona (and in a number of these
4 states – higher than toll prices in Arizona) – which further highlights my point
5 that Dr. Aron's projected savings to long-distance customers from the proposed
6 access reductions are highly doubtful.

7 **Q. DOES THIS CONCLUDE YOUR TESTIMONY?**

8 **A.** Yes.

BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS

KRISTIN K. MAYES, Chairman
GARY PIERCE
PAUL NEWMAN
SANDRA D. KENNEDY
BOB STUMP

**IN THE MATTER OF THE REVIEW AND
POSSIBLE REVISION OF ARIZONA
UNIVERSAL SERVICE FUND RULES,
ARTICLE 12 OF THE ARIZONA
ADMINISTRATIVE CODE.**

DOCKET NO. RT-00000H-97-0137

**IN THE MATTER OF THE
INVESTIGATION OF THE COST OF
TELECOMMUNICATIONS
ACCESS.**

DOCKET NO. T-00000D-00-0672

REJOINDER TESTIMONY

OF

DOUGLAS DENNEY

ON BEHALF OF

**Eschelon Telecom of Arizona, Inc.; Mountain Telecommunications, Inc.; Electric
Lightwave, LLC; McLeodUSA Telecommunications Services, Inc. d/b/a PAETEC Business
Services; tw telecom of arizona llc; and XO Communications Services, Inc.**

PUBLIC VERSION

March 5, 2010

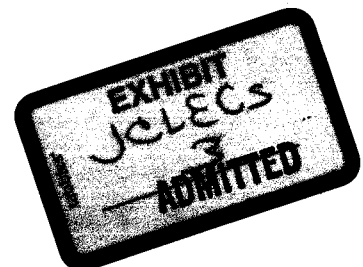


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I. INTRODUCTION

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is Douglas Denney. I work at 1201 NE Lloyd Boulevard, Suite 500, Portland, Oregon.

Q. ARE YOU THE SAME DOUGLAS DENNEY WHO PREVIOUSLY FILED TESTIMONY IN THIS PROCEEDING?

A. Yes, I filed direct testimony on December 1, 2009 and reply testimony on February 5, 2010.

Q. DO YOU HAVE ANY CORRECTIONS TO YOUR REPLY TESTIMONY?

A. Yes. On pages 43-44 of my reply testimony I evaluated Staff's proposal that all intrastate access rates be capped at Qwest's intrastate access rates by using Dr. Aron's nationwide intrastate toll and access rate data. I observed from Dr. Aron's data that while there were states with average intrastate access rates as low as Qwest's Arizona intrastate access rates, average intrastate toll prices in those states were on average the *same* as intrastate toll prices in Arizona. In other words, the data Dr. Aron offers does not show a correlation between lower access rates and lower intrastate toll prices. While this observation requires no correction, statistics underlying this conclusion that I quoted on page 43 lines 11 and 15 require minor corrections¹ – corrections that only re-enforce my

¹ The numbers presented in my reply testimony are based on a count of observations that are *strictly* below Qwest's Arizona intrastate rates, while the intention was to count of observations

1 conclusion. Specifically, based on Dr. Aron's data set of nationwide access and
2 toll rates, there are *****BEGIN HIGHLY CONFIDENTIAL [REDACTED] END**
3 **HIGHLY CONFIDENTIAL***** observations (out of 200) with intrastate access
4 rates at or below Qwest's Arizona intrastate access rates. The average intrastate
5 toll price that correspond to these observations is *****BEGIN HIGHLY**
6 **CONFIDENTIAL [REDACTED] END HIGHLY**
7 **CONFIDENTIAL*****, which is the same as Arizona's current average intrastate
8 toll price.

9 **Q. WHAT IS THE PURPOSE OF THIS TESTIMONY?**

10 A. The purpose of this testimony is to respond to selected issues raised in reply
11 testimonies of other parties as they relate to the issues and positions of the Joint
12 CLECs as outlined in my direct and reply testimonies. Like my direct and reply
13 testimonies, this testimony is organized by issue as they were outlined in the
14 procedural order.²

15 **Q. PLEASE SUMMARIZE YOUR TESTIMONY.**

16 A. No party has demonstrated that Joint CLEC access rates are unjust or/and
17 unreasonable or above cost. A strategic effort by interexchange carriers ("IXCs")
18 to avoid the cost of using local exchange carrier ("LEC") networks is not
19 justification to reduce intrastate access rates in Arizona. There is no reason to
20 require Joint CLECs to reduce their intrastate access rates at this time.

that are below or equal to Qwest's Arizona intrastate rates.

² *Procedural Order*, September 29, 2009, pp. 4-5.

1 Evaluating whether rates are just and reasonable cannot be accomplished by
2 simply comparing rates charged by different carriers or even the same carriers in
3 different states, where different markets and regulation may apply, or where
4 incumbent local exchange carriers ("ILECs") were permitted to shift revenue
5 recovery in exchange for reductions in access rates. The only valid comparisons
6 are to the cost of IXC alternatives to switched access charges and ultimately to the
7 underlying cost of switched access service. The IXC testimony generally
8 dismisses the alternatives available to it, such as competing for the end user
9 customer or purchasing facilities, such as special access, to by-pass switched
10 access. They ignore these alternatives because, by comparison, these alternatives
11 demonstrate that the Joint CLEC access rates are well within reason. IXCs
12 similarly ignore the special access alternative because evaluating that alternative
13 would draw attention to rates that are multiple times economic cost. Further,
14 IXC's proposals are not based on cost, but instead advocate rates that are equal to
15 Qwest's intrastate or interstate rates. The IXC testimony ignores differences
16 between business and residential customer networks that may explain real cost
17 differences and instead proposes a one-size-fits all approach for every carrier in
18 the state of Arizona.

19 To the extent the Commission elects to reduce CLEC access rates at this time, the
20 Joint CLECs propose that reductions be phased in gradually to minimize the
21 impact to CLECs and their end user customers.

1 A summary of the Joint CLEC proposals is more fully outlined in my rebuttal
2 testimony.³

3 **II. ISSUES POSED BY THE PROCEDURAL ORDER**

4 **Issue 1. What carriers should be covered by access reform?**

5 **Joint CLEC Access Rates are Just and Reasonable**

6
7 **Q. DOES THE STANDARD "JUST AND REASONABLE" IMPLY THAT**
8 **RATES SHOULD BE EXACTLY THE SAME FOR ALL PROVIDERS?**

9 A. No. Dr. Aron assumes that telecommunications services are a simple, single
10 product commodity and then expects a textbook ideal (absolute equality of rates)
11 to result. However, in reality telecommunications is a complex, multiproduct
12 environment that does not fit within that simplified model. Even if we look at the
13 long-distance industry (one subset of telecommunications services), which Dr.
14 Aron heralds for its "competitiveness," we find significant rate variations. For
15 example, while AT&T residential calling plans charge 10 cents per minute for
16 interstate calling with a \$2.99 monthly fee, other carriers may charge only ~~\$2.50~~ 2.5 ¢
17 cents per minute with lower monthly fee.⁴ AT&T residential long-distance rates
18 are four times higher than rates of some of its competitors – which is a much
19 bigger gap than the gap between the Joint CLEC and Qwest intrastate access

³ Denney Reply, pp. 3-6.

⁴ Based on <http://www.saveonphone.com/>, a number of carriers charge a rate of 2.5 cents per minute for interstate calls. I verified the charges of one of them, UniTel (<https://www.unitelgroup.com/rates.asp>), which service is available in Arizona.

1 rates. This example illustrates that in real life prices may vary because companies
2 operate in multi-product markets and different market niches, have various
3 geographical footprints, and have unique cost structures.⁵

4 While Qwest operates in both residential and business markets, the Joint CLECs
5 focus on the business markets. A larger portion of network cost is traffic sensitive
6 for a business customer, when compared with a residential customer: Network
7 resources necessary to serve a typical residential customer would constitute one
8 “voice channel” (channel that remains idle most of the day), while network
9 resources necessary to serve one business customer are often sized based on usage
10 of a particular customer – the more calls the business makes and receives, the
11 more “voice channels” it would require. The number of business lines (“voice
12 channels”) associated with a business customer often exceeds of the number of
13 loops serving that business location. In addition, these voice channels can often
14 come at the expense of “data channels” – i.e. more voice usage can mean less
15 usage available to data. As a result, the loop costs associated with the portion of
16 the network used to serve business customers is often traffic sensitive, which is
17 less likely to be the case for residential customers. It follows that business
18 customers impose higher network (and access) costs on the serving LEC

⁵ As incumbent local exchange carriers, Verizon and AT&T take full advantage of this economic reality by charging different rates for the same “service” – unbundled loops. In setting TELRIC rates, Commissions recognize that differences in density, geography, etc. cause the ILEC to have different costs amongst and between themselves, and in fact they have up to three separate costs for the same service within a single state. Yet, for switched access, the IXC affiliates of these entities are effectively telling the Commission that it should ignore those factors in determining just and reasonable rates for CLECs.

1 compared to residential customers (even on a “per voice channel basis”). Dr.
2 Aron’s testimony that the “costs of the loop are independent of the usage on the
3 loop, and most important, *are dedicated to a particular customer*,”⁶ is inconsistent
4 with the way businesses order and use service in today’s environment. For many
5 business customers, the relationship between the user of a telephone line and the
6 loop serving the business is not one-to-one as it typically is for a residential
7 customer. Failure to recognize this fact, denies proper usage based cost recovery.

8 Additionally, even if Qwest’s access rates *were* set at cost, because Qwest’s
9 cost/rates would be averaged across business and residential markets, these rates
10 would likely under-recover access cost of serving just business markets.

11 **Q. WHAT IS YOUR RESPONSE TO DR. ARON’S AND DR. OYEFUSI’S**
12 **ARGUMENT THAT LECS POSSESS MARKET POWER IN ACCESS**
13 **SERVICE?**⁷

14 A. It is significant that AT&T witnesses prefer the term “market power,” rather than
15 a much stronger term “terminating (or originating) monopoly.”⁸ “Market power”
16 is not the same as “monopoly;” and to a certain extent market power is present in
17 most real world markets (as opposed to the extreme textbook ideals of “perfectly
18 competitive” and “monopoly” markets). *Possessing a certain degree* of market

⁶ Aron Reply, p. 36.

⁷ This argument is addressed in detail in Aron Reply, pp. 12-20. Dr. Oyefusi’s Reply testimony (pp. 3-6) re-iterates conclusions made in Dr. Aron’s testimony but lacks the specifics arguments made by Dr. Aron. Therefore, I address this issue by focusing on Dr. Aron’s specific arguments and analysis.

⁸ In her analytical discussion on pp. 12-20, Dr. Aron uses the term “monopoly” only when citing the FCC language.

1 power is not the same as *exploiting* market power, is not the same as having a
2 *monopoly* and is certainly not the same thing as charging unjust or unreasonable
3 rates.

4 To judge whether market power has been abused, one would have to look at
5 margins (the degree by which price exceeds cost) and compare them to other
6 margins observed in the industry. As I noted in my direct testimony,⁹ for other
7 services where ILECs allege they face market pressures, such as special access
8 service, it is a common practice for regulators to allow rates that are many
9 multiples of cost (triple- and quadruple-digit margins).¹⁰ Further, as I noted in my
10 reply testimony,¹¹ if CLECs *had* sufficient market power to unilaterally impose
11 any access rate, their access rates would likely have been *much* higher. For
12 example, CLECs could have set their access rates at the level of Arizona RLECs,
13 some of which are as high as 27.8 cents a minute.¹² Instead, the Joint CLECs'
14 composite terminating access rates are in the vicinity of 4 to 5 cents.

15 Dr. Aron says that AT&T (the CLEC) has not reduced its access rates because it
16 does not want to "leave money on the table,"¹³ which would be "irresponsible to

⁹ Denney Direct, pp. 44-47.

¹⁰ This point was the reason I brought up the issue of special access in my direct testimony. Dr. Oyefusi's Reply testimony (p. 30) appears to miss this point and misrepresents my testimony by suggesting that I am trying to make the issues of FCC's Triennial Review Order and Triennial Review Remand Order an Arizona matter. Further, Dr. Oyefusi is incorrect that special access is a federal issue (Oyefusi Reply, p. 30) because Arizona intrastate special access is an issue of the Arizona Commission.

¹¹ Denney Reply, p. 10.

¹² Shand Direct, Exhibit WMS-1 (Southwestern).

¹³ Aron Reply, p. 40.

1 its shareholders.”¹⁴ Yet, AT&T’s (the CLEC) terminating access rates are in the
2 same range as the Joint CLECs rates¹⁵ – rather than at the levels of Arizona
3 RLECs. So there must be some market constraints that prevented (*i.e.*
4 constrained) AT&T (and the joint CLECs) from setting their intrastate access
5 rates at significantly higher levels, such as the rates of Arizona RLECs.

6 **Q. DR. ARON ARGUES THAT LECS POSSESS MARKET POWER IN**
7 **ACCESS SERVICE ON THE GROUNDS THAT IXCS CANNOT PRICE**
8 **TOLL SERVICES SO AS TO PASS ACCESS CHARGES ON END**
9 **USERS.¹⁶ PLEASE RESPOND.**

10 **A.** Dr. Aron’s argument is two-prong. First, she claims that IXCs do not have
11 systems in place to inform the end-user about access cost associated with a
12 particular call.¹⁷ Putting these systems in place would not require a technological
13 revolution: For example, receiving a real-time message about a call is not science
14 fiction but current practice: (1) pre-paid calling card users may be given
15 information about the “budgeted” call duration; (2) subscribers to the “call
16 waiting” feature receive information about the party that is calling the subscriber

¹⁴ *Id.*

¹⁵ While Table 1 from my Direct and Reply testimony (pp. 19 and 2 correspondingly) shows AT&T composite rate as being \$0.04223, AT&T data response to JCLEC 1-16 (question about Arizona intrastate switched access rates that AT&T (TCG) charges its affiliates) quotes a slightly higher number at \$0.047724. In a supplemental response to this data request AT&T notes that it had been erroneously charging its affiliates a rate for intrastate intraLATA traffic that is lower than \$0.047724, and that this error has been corrected. It follows that Table 2 on page 39 of Dr. Aron’s Direct testimony (table that contains CLECs composite access rates derived from billing data) contains an incorrectly low number for AT&T (the CLEC).

¹⁶ Aron Reply, pp. 12-20.

¹⁷ Aron Reply, pp. 13-15.

1 while he or she is talking to somebody else; and (3) wireless users may be
2 informed in the middle of the call that they entered a roaming area where higher
3 charges apply.

4 Second, Dr. Aron claims that provisions of section 254(g) of the federal
5 Telecommunications Act preclude IXCs from pricing intrastate toll services in
6 relation to access cost. A plain reading of section 254(g)¹⁸ and the corresponding
7 federal rules (47 C.F.R. §64.1801¹⁹) suggest that Dr. Aron's interpretation is too
8 broad. The rules focus on the difference between urban and rural toll rates,
9 which is not "the dimension" of the discussion about CLECs access rates. While
10 adopting 47 C.F.R. §64.1801, the FCC noted as follows:

11 Different rate structures may satisfy our rule. For instance, we
12 believe that carriers that offer their customers rates based on
13 reasonable differences in duration, time of day, and mileage bands
14 will satisfy their obligations under Section 254(g) to provide
15 geographically averaged rates between subscribers in rural and
16 high-cost areas and subscribers in urban areas... Although we do
17 not specify any particular alternative approaches, we believe there
18 may be other rate schemes that are consistent with the statute's
19 geographic rate averaging requirement. We do not believe that

¹⁸ Section 254(g) says as follows: "INTEREXCHANGE AND INTERSTATE SERVICES.-- Within 6 months after the date of enactment of the Telecommunications Act of 1996, the Commission shall adopt rules to require that the rates charged by providers of interexchange telecommunications services to subscribers in rural and high cost areas shall be no higher than the rates charged by each such provider to its subscribers in urban areas. Such rules shall also require that a provider of interstate interexchange telecommunications services shall provide such services to its subscribers in each State at rates no higher than the rates charged to its subscribers in any other State."

¹⁹ The rule says as follows: "(a) The rates charged by providers of interexchange telecommunications services to subscribers in rural and high-cost areas shall be no higher than the rates charged by each such provider to its subscribers in urban areas. (b) A provider of interstate interexchange telecommunications services shall provide such services to its subscribers in each U.S. state at rates no higher than the rates charged to its subscribers in any other state."

1 Section 254(g) requires carriers to assess geographically averaged
2 state and local gross-receipts taxes.²⁰

3 In his dissent of the FCC *CLEC Access Charge Order*, Commissioner Furchtgott-
4 Roth noted that

5 the language of the statute merely requires “providers of
6 interexchange telecommunications services” – IXC’s – to provide
7 “interexchange telecommunications services” at the same rates in
8 different geographic areas. It says nothing about the rates for
9 exchange access, which are generally imposed by local exchange
10 carriers and for which IXC’s act merely as billing agents. From the
11 IXC’s perspective, these charges are no different than state-specific
12 gross receipts taxes, which the Commission already allows IXC’s to
13 pass through to end users on a deaveraged basis. *See Policy and*
14 *Rules Concerning the Interstate, Interexchange Marketplace,*
15 *Implementation of § Section 254(g) of the Communications Act of*
16 *1934, as amended*, 11 FCC Rcd 9564 at ¶ 12. Section 254(g) thus
17 need not prohibit IXC’s from passing through the actual costs of
18 exchange access to their end users.²¹

19 He also noted that

20 some carriers, such as iPhonebill, implicitly pass access charges on
21 to customers. Rates for their long-distance service vary by the
22 combination of the originating and terminating area code and
23 carrier-specific three-digit exchanges. The IXC iPhonebill charges
24 more for calls with higher access charges and less for those with
25 lower access charges. Because customers, rather than the IXC,
26 bear the risk associated with the distribution of access charges,
27 iPhonebill does not charge an insurance premium for bearing that
28 risk. Consequently, iPhonebill’s rates are among the lowest of any
29 IXC.²²

²⁰ *Policy and Rules Concerning the Interstate, Interexchange Marketplace, Implementation of § Section 254(g) of the Communications Act of 1934, as amended*, CC Docket No. 96-61, Report and Order, August 7, 1996, ¶ 12.

²¹ *In the Matter of Access Charge Reform*, Seventh Report and Order and Further Notice of Proposed Rulemaking, CC Docket No. 96-262; FCC 01-146, April 27, 2001 (“CLEC Access Charge Order”), Dissent Commissioner Furchtgott-Roth, page 6.

²² *Id.*

1 Of course, another example is AT&T's in-state connectivity fee.²³ The federal
2 rules require that "[a] provider of interstate interexchange telecommunications
3 services shall provide such services to its subscribers in each U.S. state at rates no
4 higher than the rates charged to its subscribers in any other state."²⁴ Yet, AT&T
5 charges different in-state connectivity fees in different states. Qwest's Ms. Eckert
6 notes that the express purpose of in-state connectivity fee is to cover high access
7 cost.²⁵ In other words, AT&T's claim that legal or practical considerations
8 prevent IXC's from pricing toll services so as to reflect the differences in access
9 cost are incorrect: Some IXC's, including AT&T, have been doing just that.²⁶

10 **Q. WHAT IS WRONG WITH DR. ARON'S POINT THAT THE JOINT**
11 **CLECS CHARGE LOWER INTRASTATE RATES IN STATES**
12 **"NEIGHBORING" ARIZONA, AS WELL AS LOWER INTERSTATE**
13 **RATES?**²⁷

14 **A.** First, it is unclear how Dr. Aron chose Arizona's neighbors. Figure 1 in her
15 rebuttal testimony compares the rates for PAETEC, tw telecom and XO
16 Communications in New Mexico, *Texas*, and California. She doesn't explain
17 why she failed to include Colorado, Utah and Nevada.²⁸

²³ Denney Direct, pp. 64-65.

²⁴ 47 C.F.R. §64.1801(b).

²⁵ Eckert Reply, p. 13.

²⁶ According to Mr. Price (Price Reply, pp. 11-12), the Massachusetts access order that capped CLECs rates found only practical (rather than legal) obstacles to geographic de-averaging of intrastate rates.

²⁷ Aron Reply, pp. 24-25.

²⁸ If she had done this comparison she would have seen that the rates in Colorado and Utah are

1 Further, considering Dr. Aron's purpose, which is to "show" that CLECs are
2 *willing* to charge lower access rates than their Arizona access rates, she has
3 selected states that do nothing to bolster her claim. The three states selected by
4 Dr. Aron are jurisdictions where CLECs access rates have been capped;²⁹ and Dr.
5 Aron's argument incorrectly implies that rates and underlying market and cost
6 conditions should be the same in Arizona, California, Texas and New Mexico.³⁰

7 **Q. IS A COMPARISON OF CLEC ACCESS RATES TO QWEST ACCESS**
8 **RATES THE PROPER COMPARISON TO DETERMINE WHAT ACCESS**
9 **RATES A MARKET WOULD GENERATE?**

10 A. No. LEC and CLEC access services do not directly compete and generally are
11 not substitutes for each other. The relevant competition is between CLEC access
12 rates and the IXC's ability to self provision access. As mentioned in my reply
13 testimony one method of doing this is by acquiring the end user customer, and
14 thus avoiding access charges, through retail competition.³¹ Another method,
15 which IXCs employ, is the use of special access facilities (facilities used to by-
16 pass switched access that are charged on a per month basis) to avoid usage-based
17 switched access charges services. The IXC can purchase channel terminations to
18 connect an IXC point of presence directly to an end user, thus avoiding access

closer to those in Arizona and the rates in Nevada, which are capped, are closer to those in New Mexico.

²⁹ Oyefusi Direct, pp. 24-25 and Exhibit F; Price Direct pp. 15-16.

³⁰ It should also be noted that California capped CLEC access rates at the ILEC rate plus 10% and allowed for a transition period (see Eckert Direct, p. 8, fn 1). New Mexico allowed for a three year transition period to implement rates. Texas allows CLECs the option to demonstrate its own cost.

³¹ Denney Reply, pp. 8-15.

1 charges. A 2-wire, standard voice, channel termination from Qwest's interstate
2 access tariff³² is \$21.47 per month.³³ At an access rate of \$0.053, this option
3 would become attractive when an end user generated 7 hours (or more) of access
4 minutes a month.³⁴ If the cost of bypass alternatives were to significantly
5 decrease, then there would be additional pressure on LECs to reduce access rates
6 in order to compete with this alternative. While AT&T IXC and Verizon IXC are
7 quick to call for regulation of LEC access rates, AT&T LEC and Verizon LEC are
8 strong opponents of attempts to reduce the cost of special access services,³⁵ which
9 can be used by IXCs as an alternative to switched access. In other words, IXCs
10 are opposing price regulation on one important competitive alternative to
11 switched access (i.e. special access), while at the same time complaining that
12 switched access rates are high because there are not competitive options to
13 switched access. The other irony of the IXC advocacy is, as explained in my
14 direct testimony,³⁶ that the ILEC operations of carriers such as AT&T and

³² Interstate, rather than intrastate rate, is likely appropriate because traffic from the end-user would likely be a mix of interstate and intrastate traffic which generally allows a buyer to purchase from the Interstate access tariff (see Qwest Tariff FCC No. 1 section 2.3.11).

³³ Qwest's FCC Tariff #1, Section 7.4.4.A
(http://tariffs.qwest.com:8000/idc/groups/public/documents/tariff/htmltoc_fcc1.htm).

³⁴ There may be costs in addition to the channel termination, but the point is that CLEC access rates are very reasonable when compared to the IXC's alternative. For larger business customers the IXC can purchase DS1 or DS3 channel terminations which are more likely to be economical for high volume users.

³⁵ See for example recent comments by AT&T and Verizon before the FCC In the Matter of Special Access Rates for Price Cap Local Exchange Carriers, WC Docket No. 05-25 and RM-10593. Reply Comments of AT&T Inc., February 24, 2010
(<http://fjallfoss.fcc.gov/ecfs/document/view?id=7020390697>) and Reply Comments of Verizon and Verizon Wireless, February 24, 2010
(<http://fjallfoss.fcc.gov/ecfs/document/view?id=7020390675>).

³⁶ Denney Direct, pp. 40-48.

Verizon charge rates for special access multiple times in excess of economic cost, while at the same time arguing CLEC access rates are unjust and unreasonable and should be significantly reduced without regard to cost.

The Commission Should Also Establish the Terminating Rate for Intrastate, IntraMTA Wireless Calls

Q. DR. OYEFUSI SUGGESTS THAT YOUR PROPOSAL THAT THE COMMISSION SET DEFAULT INTRA-MTA RATES FOR WIRELESS CALL TERMINATION (PROPOSAL TO SET THEM TO CLEC ACCESS RATES) IS “WRONG.”³⁷ MESSRS. APPLEBY AND PRICE SIMILARLY THINK IT IS OUTSIDE THE SCOPE OF THIS PROCEEDING.³⁸ PLEASE RESPOND.

A. Dr. Oyefusi, and Messrs. Appleby and Price failed to notice that this proposal makes sense when my general proposal about CLECs access rates is considered: Regarding access rates, I propose that if the Commission mandates CLECs access rate reductions, these reductions should be based on cost.³⁹ Regarding intraMTA rates, I propose that these rates be set based on CLECs access rates (which is, given my general proposal on access rates, is equivalent to saying “based on CLECs cost”). Dr. Oyefusi is correct that intraMTA rates are subject to reciprocal compensation rules (47 CFR §§51.701-51.717). Under these rules,

³⁷ Oyefusi Reply, pp. 28-29.

³⁸ Appleby Reply, p. 21, Price Reply, p. 42.

³⁹ Denney Direct, p. 8.

1 state commissions have the authority to set these rates.⁴⁰ These rules also allow
2 the non-ILEC (or smaller ILEC) to charge higher/asymmetrical rates if the carrier
3 can show that its cost is higher than the ILEC's (or larger carrier's) cost.⁴¹ Given
4 that a cost study to determine switched access cost would contain many of the
5 same components as a cost study to determine cost of wireless call termination, it
6 is only logical that the two are determined at the same time. In addition, Mr.
7 Appleby brought up the issue of intraMTA traffic termination and the need to
8 level the playfield for wireless and wireless long-distance services.⁴²

9 **Issue 2. To what target level should access rates be reduced?**

10 **Any Target Other Than The Carrier Cost is Arbitrary**

11 **Q. DR. ARON DISPUTES YOUR STATEMENT THAT IT IS STANDARD**
12 **PRACTICE TO SET REGULATED WHOLESALE RATES BASED ON**
13 **COMPANY SPECIFIC COST.⁴³ PLEASE RESPOND.**

14 A. According to Dr. Aron, "[t]he only wholesale service for which I am aware that a
15 "standard practice" exists with respect to CLEC rates is interstate switched
16 access."⁴⁴ I simply disagree with this statement. First, while there are not very
17 many examples where CLECs wholesale rates are regulated, the FCC approach to
18 regulating CLEC interstate rates is only *one example*, rather than a standard.

⁴⁰ See, for example, 47 CFR §§51.705, 51.707, 51.709, 51.711 or 51.713.

⁴¹ 47 CFR §51.711(b).

⁴² Appleby Direct, p. 8.

⁴³ Aron Reply, pp. 30-31.

⁴⁴ Aron Reply, p. 31.

1 Second, quite a few states with caps on CLEC access rates (including
2 Massachusetts discussed on pp. 21-22 of her testimony as a recent example)
3 permit carriers to charge above-cap cost-justified rates.⁴⁵ Third, reciprocal
4 compensation rates for the exchange of local traffic are another example of
5 CLECs wholesale rates that are price regulated. As I mentioned above, the FCC
6 rules (47 CFR §51.711) generally prescribe “symmetrical” reciprocal
7 compensation rates based on the ILEC’s (or larger carrier’s) cost, but allow the
8 non-ILEC (or smaller ILEC) to charge higher/asymmetrical rates if the carrier can
9 show that its cost is higher than the ILEC’s (or larger carrier’s) cost.⁴⁶ Finally,
10 more broadly, it is a standard practice to set regulated rates so that they cover the
11 company’s costs because denial of cost recovery is arguably unfair and unlawful.
12 For example, as I discussed in my reply testimony,⁴⁷ Verizon recently filed for a
13 stay of the New Jersey Board of Public Utilities access decision, arguing that the
14 ordered access rates did not permit cost recovery and therefore, were
15 unconstitutional and confiscatory.⁴⁸ Similarly, in an ongoing Connecticut case
16 that concerns AT&T reciprocal compensation and transit rates, AT&T noted that

⁴⁵ See Denney Reply, pp. 26-27.

⁴⁶ More specifically, 47 CFR §51.711(b) says as follows: “A state commission may establish asymmetrical rates for transport and termination of telecommunications traffic only if the carrier other than the incumbent LEC (or the smaller of two incumbent LECs) proves to the state commission on the basis of a cost study using the forward-looking economic cost based pricing methodology described in §§51.505 and 51.511, that the forward-looking costs for a network efficiently configured and operated by the carrier other than the incumbent LEC (or the smaller of two incumbent LECs), exceed the costs incurred by the incumbent LEC (or the larger incumbent LEC), and, consequently, that such that a higher rate is justified.”

⁴⁷ Denney Reply, p. 28.

⁴⁸ Verizon’s filing is included as Exhibit DD-1 to Denney Reply, pp. 1 and 3.

1 “the U.S. Constitution forbids confiscatory rates”⁴⁹ and “[d]enying AT&T
2 Connecticut any cost recovery for use of its switching would violate both
3 TELRIC and the Constitution.”⁵⁰

4 **Q. ACCORDING TO DR. OYEFUSI, THE NEW JERSEY BOARD FOUND**
5 **THAT CLEC ACCESS COST MODELS OVERSTATED COST.**⁵¹
6 **PLEASE RESPOND.**

7 A. Dr. Oyefusi’s reliance on the findings of a New Jersey Board is inappropriate in
8 this docket because it concerns cost models of New Jersey CLECs rather than
9 Arizona CLECs. It is *another state’s* opinion about cost models of *some other*
10 CLECs. Cost models of Arizona CLECs have not been filed in the New Jersey
11 case (or, for that matter, in this case). Extending Dr. Oyefusi’s logic to a
12 hypothetical example, he would apparently argue that the Arizona Commission
13 should not consider Qwest’s cost models simply because Verizon’s cost models
14 were critiqued by the New Jersey Board.

15 **Q. IN RESPONSE TO YOUR POINT THAT QWEST INTERSTATE RATES**
16 **ARE NOT AN APPROPRIATE TARGET FOR ARIZONA CLEC**
17 **INTRASTATE RATES BECAUSE CLECS WERE NOT A PARTY IN**
18 **NEGOTIATIONS THAT SET THESE RATES, DR. ARON CLAIMS THAT**

⁴⁹ Reply Brief of the Southern New England Telephone Company (AT&T-CT), *DPUC Investigation into the Southern New England Telephone Company’s Cost of Service RE: Reciprocal Compensation*, Connecticut Docket No. 09-04-21, December 4, 2009, p. 1.

⁵⁰ *Id.*

⁵¹ Oyefusi Reply, p. 6.

1 **CLECS SUPPORTED “THE RATES THAT WERE ULTIMATELY SET”⁵²**
2 **IN THE CALLS ORDER.⁵³ IS SHE CORRECT?**

3 A. No. A review of source documents on which Dr. Aron relies shows that she
4 simply misrepresented the CLECs’ position. Dr. Aron’s claim is based on her
5 reference to April 3, 2000 and April 17, 2000 joint comments of the Association
6 for Local Telecommunication Services (“ALTS”) and Time Warner Telecom on
7 the CALLS Modified Proposal⁵⁴ (proposal that was adopted in May 2000 CALLS
8 Order). These comments stated that “ALTS and TWTC **fundamentally object to**
9 **both the process and substance of the Modified Proposal**”⁵⁵ and critiqued the
10 key aspects of the proposed access rates. Specifically, the joint comments noted
11 that the proposed caps for per minute access rates were “**simply wild guesses**
12 without any foundation in the record or in economic reasoning.”⁵⁶ They also
13 noted that since the proposed new Subscriber Line Charge “**would bear no**
14 **relation to the costs** of the loops to which it is assigned, it **would add to the**
15 **implicit subsidies** that the Modified Proposal purports to reduce.”⁵⁷ These

⁵² Aron Reply, p. 29.

⁵³ *Access Charge Reform, Price Cap Performance Review for Local Exchange Carriers*, CC Docket Nos. 96-262 and 94-1, Sixth Report and Order, *Low-Volume Long Distance Users*, CC Docket No. 99-249, Report and Order, *Federal-State Joint Boards on Universal Service*, CC Docket No. 96-45, Eleventh Report and Order, 15 FCC Rcd 12962 (2000) (hereafter “CALLS Order”).

⁵⁴ *Joint Comments of the Association for Local Telecommunication Services and Time Warner Telecom* in CC Docket Nos. 96-262, 94-1, 99-249 and 96-45 dated April 3, 2000 (“April 3, 2000 Joint Comments”) and *Joint Reply Comments of the Association for Local Telecommunication Services and Time Warner Telecom* in CC Docket Nos. 96-262, 94-1, 99-249 and 96-45 dated April 17, 2000 (“April 17, 2000 Joint Comments”).

⁵⁵ April 3, 2000 Joint Comments, p. 3 (emphasis added).

⁵⁶ April 17, 2000 Joint Comments, p. 16 (emphasis added).

⁵⁷ April 17, 2000 Joint Comments, p. 3 (emphasis added).

1 comments “urge the Commission to reject both the Modified Proposal as well
2 as the more general attempt to rely on negotiated solutions.”⁵⁸ They propose
3 an alternative only “[i]n the event that the Commission insists on pursuing this
4 approach,”⁵⁹ and characterize its alternative proposal as “a compromise,”⁶⁰ “an
5 attempt to at least improve upon the Modified Proposal”⁶¹ and
6 “ALTS/TWTC's good faith effort to work with the Commission to accomplish its
7 needs for price reductions in the coming year.”⁶² To summarize, ALTS/TWTC
8 alternative proposal was *not a support for CALLS rates*, but a last-minute effort to
9 improve on the faulty access reduction plan that was bound to happen anyway.

10
11 **Q. MR. APPLEBY SUGGESTS THAT CARRIERS SHOULD BE WILLING**
12 **TO EXCHANGE TRAFFIC AT MARGINAL COST AND DOES NOT SEE**
13 **HOW THAT COULD BE CONFISCATORY IF RATES COVER**
14 **MARGINAL COST.⁶³ PLEASE RESPOND.**

15 **A.** It is not clear that Mr. Appleby understands the concept of marginal cost and the
16 implications of his suggestion. As noted by Dr. Johnson, “pricing at marginal
17 cost may not allow the firm to recover its total costs.”⁶⁴ Dr. Johnson also
18 correctly noted that proposals to price access at marginal costs are no better than

⁵⁸ April 17, 2000 Joint Comments, p. 4 (emphasis added).

⁵⁹ April 17, 2000 Joint Comments, p. 4 (emphasis added).

⁶⁰ April 3, 2000 Joint Comments, p. 18 (emphasis added).

⁶¹ April 3, 2000 Joint Comments, p. 15 (emphasis added).

⁶² April 17, 2000 Joint Comments, p. 7.

⁶³ Appleby Reply, pp. 9-10.

⁶⁴ Johnson Direct, p. 25.

1 proposals to price local service at marginal costs.⁶⁵ When discussing marginal
2 cost it is important to distinguish between short run marginal costs and long run
3 marginal cost. In economics, the short run is a period of time where some of the
4 inputs are fixed. An example of short run marginal cost of access would be to
5 consider the additional cost a carrier would face to add an additional minute to the
6 network. In the telecommunications industry, which has large fixed costs (most
7 network costs are fixed), short run marginal costs are close to zero (this is true,
8 not just for access, but for most telecommunications services). If one service
9 using a shared facility is priced at short run marginal cost, then in order to recover
10 total costs, other services provisioned over a shared facility would bear an unfair
11 burden of the cost of any shared facility. This is why in the telecommunications
12 industry we typically look at long run marginal cost (or long run incremental cost)
13 when cost is taken into consideration for setting rates.

14 IXC's also argue that telephone networks were built to accommodate only local
15 service⁶⁶ in attempt to explain why IXC's should not have to pay to use the LEC's
16 network. This extreme is as nonsensical as the opposite argument – that
17 telephone networks were built to accommodate only long-distance service.
18 (However, this last argument could also be advanced because some end-users may
19 value long-distance connectivity more than local connectivity). Further, Mr.
20 Appleby appears to think that marginal costs are likely to be very low (that is why

⁶⁵ Johnson Direct, p. 24.

⁶⁶ See also Oyefusi Reply, p. 27 footnote 47, suggesting that a loop was built to provide local service.

1 he likes it); however, that is not necessarily true. Short run marginal costs may
2 also be very high, which is why short run marginal cost pricing is so rarely used
3 to set regulated rates. For example, if a company is bumping up against a
4 capacity constraint that precipitate a major network expansion, the marginal unit
5 will be very expensive. Also, if Sprint tends to terminate calls at LECs at the
6 peak hour, and AT&T terminates in off peak hours, Sprint's calls have
7 significantly higher marginal costs than AT&T's. Would Mr. Appleby propose
8 that Sprint pay higher rates than AT&T?

9 The Commission should reject these unreasonable extremes that attempt to assign
10 costs to a single user of the network, and instead adopt a practical middle ground
11 – that telephone networks were built to be shared between local and long-distance
12 services.

13 **Q. DR. ARON ARGUES AGAINST YOUR SUGGESTION THAT IF THE**
14 **COMMISSION DECIDES TO CAP CLEC RATES, IT SHOULD USE**
15 **QWEST 1999 RATES. WHY IS SHE WRONG IN SAYING THAT CLECS**
16 **BENEFITED FROM RATE INCREASES CONTAINED IN QWEST'S**
17 **REVENUE NEUTRAL RATE REBALANCING (REBALANCING THAT**
18 **OFFSET QWEST'S ACCESS REDUCTIONS)?⁶⁷**

19 **A.** Dr. Aron is wrong because Qwest's rate rebalancing was not an "across the
20 board" proportional increase in retail prices. In fact, for some services Qwest was

⁶⁷ Aron Reply p. 35.

1 mandated to **reduce** prices. For example, as a result of the first price cap plan,
2 prices for some services went down, including, basic business service.⁶⁸ For
3 others services (the “flexibly-priced basket”) it was **up to Qwest** to decide which
4 rates to increase and by how much.⁶⁹ As a rational firm, Qwest increased rates in
5 the relatively less competitive areas. Therefore, CLECs would not have
6 benefited from Qwest’s rate rebalancing the way Dr. Aron suggests.

7 **Q. DO THE LEC AFFILIATES OF THE LARGE IXCS (INCLUDING**
8 **QWEST) ADVOCATE RATES MULTIPLE TIMES ECONOMIC COST IN**
9 **MARKETS WHERE THEY BELIEVE THERE IS COMPETITION?**

10 A. Yes. As mentioned previously and discussed in my direct testimony, ILECs
11 typically charge for special access circuits at levels multiple times their economic
12 cost. It makes no sense that these carriers defend a “so called” competitive
13 market for special access where Qwest charges rates that are multiple times
14 economic cost, while at the same time arguing that it is imperative that CLEC
15 access rates be reduced to low levels, without regard for cost.

16
17 **Issue 3. What procedures should the Commission implement to achieve the**
18 **desired reduction in access rates?**
19

⁶⁸ In the Matter of the Application of U S WEST Communications, Inc. for a Hearing to Determine the Earnings of the Company for Ratemaking Purposes, to fix a Just and Reasonable Rate of Return thereon and to Approve Rate Schedules, Docket No. T-01051B-99-0105 (“1999 Price Cap Docket”), US WEST Communications, Inc. Tariff Filing for Approval of a \$.25 Surcharge for a Call to a US WEST 800 Service Line from a Pay Telephone, Docket No. T-0105B-00-0369, Decision No. 63487 dated March 30, 2001 (“2001 Price Cap Decision”), p. 5.

⁶⁹ 2001 Price Cap Decision, p. 9.

**Reduction in Access Rates Should be Implemented Gradually to Allow LECs
Adequate Opportunity to Adjust Their Business Plans**

**Q. DR. ARON DEVOTES THIRTEEN PAGES OF HER TESTIMONY⁷⁰
ARGUING AGAINST YOUR PROPOSAL TO IMPLEMENT CLEC
ACCESS REDUCTIONS GRADUALLY. PLEASE RESPOND.**

A. Dr. Aron's lengthy discussion can be summed up as follows: immediate flash-cut access reductions are necessary because they will benefit long-distance customers, and CLECs can easily bear the financial burden of sudden access rate reductions. Dr. Aron's specific arguments are full of contradictions and misrepresentations of facts: While Dr. Aron believes that CLECs can simply increase their local prices to make up for access revenue losses,⁷¹ she fails to recognize that in this case the benefit to long-distance customers would be at expense of local customers.⁷² In other words, even under Dr. Aron's simplistic view, immediate benefits to long-distance customers would also mean immediate price hikes for local customers. Mr. Price was critical of this argument stating that "it rests on a misconception that somehow all customers are *either* toll customers or local service customers, but not both."⁷³

⁷⁰ Aron Reply, pp. 32-33 and 45-55.

⁷¹ Aron Reply, pp. 50-53. Of course, as I explain in my Reply testimony on pp. 31-33, this is an incorrect assumption for end-user markets in which CLECs operate.

⁷² As I showed on pp. 36-37 of my reply testimony, the historical trends in local and long-distance prices are the opposite: While long-distance prices have been generally falling, local prices were going up, so that the aggregate price index (local and long-distance services combined) remained relatively stable.

⁷³ Price Reply, p. 7. Mr. Price made this statement in critique of my testimony. However, I agree

1 In general, Dr. Aron's characterization of the retail local markets in which the
2 Joint CLECs operate is full of misconceptions: First, she points out (correctly)
3 that Joint CLECs focus on business markets and claims (incorrectly) that local
4 business rates are a source of a *subsidy*.⁷⁴ This observation is inconsistent with
5 the current (competitive) state of business markets. Mr. Price observes that "the
6 retail market for services to end user customers in Arizona is highly
7 competitive."⁷⁵ This means that if business rates were a source of a subsidy, they
8 would have been competed away. Second, she claims that Qwest's access charge
9 reductions were offset by increases in rates that were *set below cost*, and that
10 CLECs benefited from these rate increases.⁷⁶ This claim directly contradicts the
11 first claim – do CLECs operate in markets where retail rates contain a subsidy or,
12 on the contrary, are set below cost? Third, she claims that the Joint CLECs have
13 the ability to increase retail rates to offset access revenue shortfall.⁷⁷ For a
14 number of reasons this claim is incorrect. CLECs are often bound by end user

with Mr. Price that local service customers subscribe to both toll and local service. My point, which follows from Mr. Price's observation, is that this case is less about benefits to end user customers, as the IXCs have claimed, and more about a redistribution of revenues and costs between carriers and subclasses of end users.

⁷⁴ Aron Reply, p. 54. A similar statement is made in Oyefusi Reply, p. 24.

⁷⁵ Price Reply, p. 13.

⁷⁶ Aron Reply, p. 35.

⁷⁷ Aron Reply, pp. 50-53.

1 term contracts which preclude price changes to offset access revenue shortfall.⁷⁸

2 Further, Qwest as the incumbent competitor would not have an access revenue
3 shortfall and would not increase retail rates in the same markets, thus exerting
4 competitive pressure on CLECs to not raise rates. Dr. Aron's argument
5 contradicts her own testimony that "a competitive market would not permit a
6 competitor with an equivalent service to charge a price that is higher than that of
7 the incumbent."⁷⁹

8 **Q. WHAT ARE SOME OTHER CONTRADICTIONS IN DR. ARON**
9 **ADVOCACY OF THE SHORT (60-DAY) TRANSITION PERIODS?**

10 A. Dr. Aron claims that the Joint CLEC intrastate access revenues are relatively
11 small,⁸⁰ which she interprets as an argument for immediate access reduction. Yet,
12 when defending AT&T-CLEC current access rates in Arizona (which are similar
13 to access rates of the Joint CLECs), she claims that "[o]ne CLEC alone reducing
14 its access rates would have minimal effect on the average rate paid by IXCs" and

⁷⁸ While discussing the issue of term contracts on p. 52 of her Reply testimony, Dr. Aron misrepresents my testimony: Dr. Aron's language (expressions such as "Mr. Denney claims," "he does not say" and "which presumably is not the case, or Mr. Denney would have said so") mask the fact that my direct testimony (p. 52) merely cited McLeodUSA comments previously filed in the case. In other words, if I "did not say" what percentage of McLeodUSA contracts fall under certain class, that is because my source (McLeodUSA comments) did not contain that information. Further, Dr. Aron complains on page 50 that JCLECs declined to provide their term contracts omits the important nuance that the AT&T data request in question (AT&T 1-5) requested to provide "copies of all term agreements with end-user customers" for each JCLEC, which is unduly burdensome.

⁷⁹ Aron Reply, p. 36.

⁸⁰ Aron Reply, pp. 47-48. Note that Dr. Aron's specific numbers that back up her point that intrastate switched access revenue is a small percent of total CLECs revenue (contained in line 19, p. 47, line 1 p. 48 and footnote 76) are a misrepresentation: Dr. Aron reports Arizona intrastate access revenue as a percent of "global" (Arizona and other states) CLECs revenue. This approach essentially suggests that CLECs should make up the shortfall in Arizona revenues (stemming from access rate reductions in Arizona) from their end-user customers in Colorado (as an example).

1 would not “meaningfully benefit consumers.”⁸¹ Given that AT&T (the IXC)
2 offers the same per minute long-distance in-state rates,⁸² and Arizona CLECs are
3 small when compared to total intrastate traffic nationwide, access reductions by
4 Arizona CLECs would similarly have no “meaningful” benefit on consumers of
5 in-state long-distance services.

6 In response to my point that CLECs often purchase long-distance services at
7 wholesale from companies like AT&T, and that these contracts often have fixed
8 terms, Dr. Aron brings up her regression predictions according to which *retail* toll
9 prices *tend to* decrease with access rates.⁸³ Dr. Aron misses the point – retail toll
10 prices are not the same as wholesale toll prices, and her regression is too generic
11 as it does not account for the manner in which toll prices are set, blends together
12 business and residential markets and includes a large number of observations
13 outside the “relevant range” (for which intrastate access costs are significantly
14 higher than Arizona access rates).⁸⁴ As Dr. Oyefusi explained in his reply
15 testimony,⁸⁵ if the AT&T proposal is adopted, AT&T plans to remove the in-state
16 connectivity fee and reduce calling card rates. Because the in-state connectivity
17 fee is a flat monthly charge, access rate reductions would not translate linearly (as
18 assumed in Dr. Aron’s regression) into savings to end-users. In fact, high-usage
19 customers would not see their “fair” share of access cost savings.

⁸¹ Aron Reply, pp. 39-40.

⁸² Denney Direct, p. 64.

⁸³ Aron Reply, pp. 54-55.

⁸⁴ Denney Reply, pp. 40-42.

⁸⁵ Oyefusi Reply, p. 28.

1 **Q. HOW DO YOU RESPOND TO CLAIMS BY DR. ARON AND MR. PRICE**
2 **THAT ARIZONA CLECS ARE READY FOR IMMEDIATE ACCESS**
3 **REDUCTIONS BECAUSE THEY SAW ACCESS RATE CAPS IN OTHER**
4 **JURISDICTIONS?**⁸⁶

5 A. According to Dr. Aron's and Mr. Price's logic, Arizona CLECs should have been
6 pricing their retail products not based on Arizona-specific market and regulatory
7 conditions, but based on conditions and regulations in other states. Dr. Aron
8 reviews 10-K filings made by the Joint CLECs with the SEC from between 1998
9 and 2007 regarding risks associated with access reductions.⁸⁷ She equates
10 recognizing the business risks associated with access reductions to actual planning
11 to have access rates reduced. This is not the case. Almost all of the selected SEC
12 notices warn that reductions in access rates can have an impact on the CLEC's
13 business. This does not mean that the CLECs should plan to lose arguments that
14 their access rates are just and reasonable. Most of the 10-K excerpts referenced
15 by Dr. Aron involved the FCC's CALLS order. Dr. Aron concludes, "the CLECs
16 provided no evidence or examples that they have curtailed any activities (let alone
17 exited a state) as a result of access rates caps in any state."⁸⁸ Apparently Dr. Aron
18 forgot that the FCC cap on CLEC interstate access rates was followed by a wave
19 of CLECs bankruptcies.⁸⁹

⁸⁶ Aron Reply, p. 34 and Price Reply, pp. 15-16.

⁸⁷ Aron Reply, pp. 33-34 and Attachment DJA-R2.

⁸⁸ Aron Reply, p. 34. Dr. Oyefusi makes a similar statement on p. 26 of his reply testimony.

⁸⁹ While there were many factors that drove a large number of CLECs to bankruptcies, access rate

1 Dr. Aron and Mr. Price also overlook that there are many jurisdiction in which
2 this issue has been debated and no action has ensued. In fact, it is still true that
3 the majority of states have opted not to follow the FCC's access pricing policies.

4 **Issue 4. Should carriers be permitted to contract for access rates that differ from**
5 **their tariffed rates?**

6 **Carriers Should be Required to Pay Tariff Access Rates**

7
8 **Q. DR. OYEFUSI CLAIMS THAT YOUR DIRECT TESTIMONY**
9 **RECOMMENDED THAT THE ACC "NOT ALLOW CARRIERS TO**
10 **ENTER INTO CONTRACTS FOR SWITCHED ACCESS SERVICE."⁹⁰ IS**
11 **HE CORRECT?**

12 **A.** No. I only said that there should be a requirement that IXC's pay tariffed access
13 rates,⁹¹ which is not the same as "not allowing" contracts. Currently, it is
14 apparently unclear to IXC's that they should pay tariffed access rates. The absence
15 of such explicit requirement allows IXC's to simply withhold payments on their
16 access bills and bully CLECs into "agreeing" to accept lower payments. If paying
17 tariffed access rates is a "default" obligation, negotiations for contract access rates
18 would be on a somewhat more leveled playing field and contracts could be the
19 result of mutual benefit rather than economical blackmail. The Joint CLECs do
20 not oppose contract tariffs if access tariffs are treated as a "default" obligation.

reductions mandated by the FCC contributed to that phenomenon by decreasing CLECs cash flow.

⁹⁰ Oyefusi Reply, p. 30.

⁹¹ Denney Direct, p. 55.

1 As I explained in my Reply testimony,⁹² the Joint CLECs do not oppose Staff's
2 proposal that contract access tariffs be filed with the Commission.

3 **Issue 6. How much of access cost recovery, if any, should be shifted to end users?**
4 **What showing should be required for such a shift? What should be the**
5 **role of "benchmark" rates and how should benchmarks be set?**

6
7 **IXCs and Their Customers Are the Cost Causers of Traffic Sensitive Costs and Not**
8 **End Users**

9
10 **Q. MR. PRICE CLAIMS THAT PROPOSALS TO SHIFT ACCESS COST**
11 **RECOVERY TO END-USERS ARE NOT A "FREE RIDE" TO IXCS**
12 **BECAUSE LOCAL CUSTOMERS ARE ALSO LONG-DISTANCE**
13 **CUSTOMERS.⁹³ PLEASE RESPOND.**

14 **A.** Mr. Price's argument is wrong; it would hold only if there existed only one
15 telephone company (carrying both local and long-distance calls), and if each end-
16 user had the same demand for local and long-distance service. The reality is quite
17 opposite: There are numerous competing local and long-distance companies, and
18 end-users are also not created the same. For example, when a telemarketer (a
19 Verizon-IXC customer) in Phoenix calls Integra's end-user in Tucson, Integra's
20 end-user may find this call unwelcomed and distracting. The telemarketer is the
21 cost-causer.⁹⁴ Why should the Integra and/or Integra's end-user (who may

⁹² Denney Reply, p. 34.

⁹³ Price Reply, pp. 6-7.

⁹⁴ According to Mr. Price (Price Reply, p. 11), the Massachusetts access order that capped CLECs rates found just that – that the calling party is the cost-causer.

1 subscribe to AT&T long-distance) subsidize network cost associated with a
2 Verizon customer?

3 Further, IXC's note that reducing long-distance prices would stimulate long-
4 distance demand.⁹⁵ Similarly, increasing local prices would depress demand for
5 local services. Because LECs and IXC's are not the same entities, the impact of
6 potential "free ride" and re-distribution of revenue streams is not a trivial issue.

7 Finally, because end-users purchase and use of local and long-distances services
8 are often unique, proposals to shift cost recovery could lead to cross-subsidies and
9 a re-distribution of wealth between end-users. For example, end-user X may
10 make and receive a lot of long-distance calls, while end-user Y may not use long-
11 distance services at all. A regulator may find it undesirable to make end-user Y
12 pay the same (flat-rated) amount for access to long-distance networks as the first
13 end-user. After decades of trying to eliminate cross-subsidies from
14 telecommunications prices, this is not the time for regulators to create new ones.

15 **Q. DRS. ARON AND OYEFUSI CLAIM THAT NO LOOP COST CAN BE**
16 **ATTRIBUTED TO SWITCHED ACCESS SERVICE.⁹⁶ PLEASE**
17 **EXPLAIN WHY THIS POSITION IS INCORRECT.**

18 **A.** Drs. Aron and Oyefusi deny a commonly accepted fact – that loop is a facility
19 shared by several services, and as a result, the cost of loop facility is attributable

⁹⁵ Aron Direct, pp. 66-67.

⁹⁶ Aron Reply, pp. 36-39 and Oyefusi Reply, pp. 26-28.

1 to all services that share this facility, including switched access and long-distance
2 services. Indeed, if not for local loops, a long-distance call could not be
3 completed (or an IXC would have to build its own facilities to reach the called
4 party). Dr. Oyefusi's comment that "[t]he loop is built for the purpose of
5 providing local service"⁹⁷ is nonsensical: If that were the case, IXCs would be
6 building their own loops (parallel to the existing LEC loops) to reach end-users.

7 Regulators also treat loop cost as attributable to both local and access services.
8 For example, in its *Local Competition Order*, the FCC noted that "[t]he costs of
9 local loops and their associated line cards in local switches, for example, are
10 common with respect to interstate access service and local exchange
11 service[.]"⁹⁸ Similarly, the FCC 2008 *FNPRM* in the intercarrier compensation
12 docket noted that "the subscriber line charge (SLC) that the Commission
13 established is intended to capture the *interstate* cost of the *local* loop."⁹⁹ Clearly,
14 the existence of "interstate cost of local loop" and the interstate SLC (an *access*

⁹⁷ Oyefusi Reply, p. 27 footnote 47.

⁹⁸ In the Matter of Implementation of the Local Competition Provisions in the Telecommunications Act of 1996, Interconnection between Local Exchange Carriers and Commercial Mobile Radio Service Providers, CC Docket Nos. 96-98 and 95-185, *First Report and Order*, adopted August 1, 1996, ¶ 678 (emphasis added).

⁹⁹ In the Matter of *High-Cost Universal Service Support*, WC Docket No. 05-337, *Federal-State Joint Board on Universal Service*, CC Docket No. 96-45, *Lifeline and Link Up*, WC Docket No. 03-109, *Universal Service Contribution Methodology*, WC Docket No. 06-122, *Numbering Resource Optimization*, CC Docket No. 99-200, *Implementation of the Local Competition*, CC Docket No. 96-98, *Provisions in the Telecommunications Act of 1996*, CC Docket No. 01-92, *Developing a Unified Intercarrier Compensation Regime*, CC Docket No. 99-68, *Intercarrier Compensation for ISP-Bound Traffic IP-Enabled Services*, WC Docket No. 04-36, *Order On Remand And Report And Order And Further Notice Of Proposed Rulemaking*, released November 5, 2008 ("FNPRM"), Appendix A ¶ 104 (emphasis original to the source).

1 charge) is an indicator that local loop is attributable to more than just local
2 services.

3 **Q. DOES DR. ARON CONFUSE WHETHER LOOP COST SHOULD BE**
4 **ATTRIBUTED TO ACCESS WITH HOW LOOP COST IS RECOVERED?**

5 A. Yes. Dr. Aron claims that no loop cost should be attributed to access services,¹⁰⁰
6 but in support cites sources that discuss *recovery* of the “interstate portion”¹⁰¹ of
7 loop cost through flat-rated charges – which is not the same. As noted by Staff’s
8 Mr. Shand, loop cost is recovered in a different manner in Arizona compared with
9 the federal jurisdiction, where the FCC uses a flat-rated method.¹⁰² The FCC
10 approach is far from ideal. For example, as noted above, ALTS critiqued the
11 federal CALLS plan on the grounds that the federal SLC rates are set at the same
12 generic level across states and carriers: Because loop cost vary significantly
13 across states and carriers, the use of the same generic level of SLC charges means
14 that these rates are not tied to loop cost that they intend to recover.¹⁰³ In Qwest’s
15 AFOR docket the Commission noted “[w]hile we agree that achieving parity
16 between intrastate and interstate switched access rates is a laudable goal, there

¹⁰⁰ Aron Reply, p. 37 lines 6-7 and p. 38 lines 1-2.

¹⁰¹ Aron Reply, p. 38 line 13 (citing the FCC).

¹⁰² Shand Reply, p. 4 (“Interstate access charges are generally lower than intrastate access charges because of the manner in which costs that have been allocated to interstate access are recovered.”)

¹⁰³ April 17, 2000 Joint Comments, p. 3.

1 are many other public policy issues that impact our ability to reach that goal,
2 such as the desirability of imposing an End User Common Line charge.”¹⁰⁴

3 **Q. REBUTTING YOUR POINT THAT IXCS BENEFIT FROM THE LOCAL**
4 **LOOP, DR. ARON PROVIDES AN ANALOGY OF HANDSETS. SHE**
5 **SUGGESTS THAT IT WOULD BE UNREASONABLE TO EXPECT IXCS**
6 **“SUBSIDIZE” HANDSETS.¹⁰⁵ PLEASE RESPOND.**

7 **A.** Dr. Aron’s analogy is not convincing. Apart from the fact that handset
8 subsidization is a common market practice in wireless industry,¹⁰⁶ handsets do not
9 provide a good analogy to local loop because handset costs are significantly lower
10 than loop cost. For example, a handset may cost just a few dollars per year
11 (spreading its price over its lifetime),¹⁰⁷ while annual cost of a loop would be
12 measured in hundreds of dollars.¹⁰⁸ Because the cost of a loop (a shared asset) is
13 very high compared to the cost of a handset, the issue of fair cost allocation is
14 more urgent for a loop than for a handset. Indeed, if the cost of a loop *were* as
15 low as the cost of a handset, the regulatory landscape (which is driven to a large

¹⁰⁴ 1999 Price Cap Docket, ACC Decision No. 63487 (March 30, 2001), p. 12 (emphasis added).

¹⁰⁵ Aron Reply, p. 37.

¹⁰⁶ See the FCC report on Wireless Competition (*13th Report* in WT Docket No. 08-27 released on January 16, 2009), p. 60: “Fixed-term service contracts and ETFs [Early Termination Fees] are part of a traditional industry business model in which providers use handset subsidies to offer consumers a discount on the upfront price of handsets and thereby promote the sale of mobile telephone services.”

¹⁰⁷ AT&T Corded Basis Trimline Phone sold currently at target.com is priced at \$5.99.

¹⁰⁸ For example, based on the latest cost data contained in the annual Universal Service Fund filing of National Exchange Carrier Association cost data available at <http://www.fcc.gov/wcb/iatd/neca.html>, Qwest-Arizona annual average loop cost per line was \$413.15. For several Arizona carriers annual average loop cost per line was over one thousand dollars, with Accipiter having the highest annual average loop cost per line at \$9,495.48.

1 extent by the notion that loop facilities represent a bottleneck and a barrier to
2 entry) would be much different from what we have today. Further, as described
3 above, for most business customers the loop is traffic sensitive, unlike a handset,
4 in that multiple loops or capacity is purchased based on the business's usage
5 requirements. This is the same way long distance networks are built – based on
6 the demand that will travel over them. It is understandable that IXC's want
7 CLECs to give access to their facilities for free; however, this is not the practice
8 of any business, including IXC's, who rightly charge carriers that use capacity on
9 their network.

10 **Q. DOES THIS CONCLUDE YOUR TESTIMONY?**

11 **A. Yes.**

BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS

KRISTIN K. MAYES - Chairman
GARY PIERCE
PAUL NEWMAN
SANDRA D. KENNEDY
BOB STUMP



IN THE MATTER OF THE REVIEW AND
POSSIBLE REVISION OF ARIZONA UNIVERSAL
SERVICE FUND RULES, ARTICLE 12 OF THE
ARIZONA ADMINISTRATIVE CODE.

Docket No. RT-00000H-97-0137

IN THE MATTER OF THE INVESTIGATION OF
THE COST OF TELECOMMUNICATIONS
ACCESS.

Docket No. T-00000D-00-0672

DIRECT TESTIMONY OF

DR. DEBRA J. ARON

On Behalf of

AT&T Communications of the Mountain States, Inc. and TCG Phoenix

December 1, 2009

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Exhibit DJA-1 Curriculum Vitae.

DOCKET No. RT-00000H-97-0137
DOCKET No. T-00000D-00-0672
AT&T COMMUNICATIONS OF THE MOUNTAIN STATES, INC.
AND TCG PHOENIX
DIRECT TESTIMONY OF DR. DEBRA J. ARON

I. Introduction and Qualifications

Q: PLEASE STATE YOUR NAME AND POSITION.

A: My name is Debra J. Aron. I am the Managing Director of the Evanston offices of LECG, LLC, ("LECG") and Adjunct Associate Professor at Northwestern University. LECG is an economics and finance consulting firm that provides economic expertise for litigation, regulatory proceedings, and business strategy. My business address is 1603 Orrington Avenue, Suite 1500, Evanston, IL, 60201.

Q: PLEASE DESCRIBE YOUR PROFESSIONAL QUALIFICATIONS.

A: I have a Ph.D. in economics, have taught economics at Northwestern University for most of the last 23 years, and have presented testimony on communications issues for over 12 years. I received a Ph.D. in economics from the University of Chicago in 1985, where my honors included a Milton Friedman Fund fellowship, a Pew Foundation teaching fellowship, and a Center for the Study of the Economy and the State dissertation fellowship. I was an Assistant Professor of Managerial Economics and Decision Sciences from 1985 to 1992, at the J. L. Kellogg Graduate School of Management, Northwestern University, and a Visiting Assistant Professor of Managerial Economics

1 and Decision Sciences at the Kellogg School from 1993-1995. I was named a National
2 Fellow of the Hoover Institution, a think tank at Stanford University, for the academic
3 year 1992-1993, where I studied innovation and product proliferation in multiproduct
4 firms. Concurrent with my position at Northwestern University, I also held the position
5 of Faculty Research Fellow with the National Bureau of Economic Research from 1987-
6 1990. At the Kellogg School, I have taught M.B.A. and Ph.D. courses in managerial
7 economics, information economics, and the economics and strategy of pricing. I am a
8 member of the American Economic Association and the Econometric Society. My
9 research focuses on communications markets, multiproduct firms, innovation, incentives,
10 and pricing, and I have published articles on these subjects in several leading academic
11 journals, including the *American Economic Review*, the *RAND Journal of Economics*,
12 and the *Journal of Law, Economics, and Organization*. I currently teach a graduate
13 course in the economics and strategy of communications industries at Northwestern
14 University.

15 I have consulted on numerous occasions to the telecommunications industry on
16 competition, costing, pricing, incentives, and regulation issues in the United States and
17 internationally. I have testified before regulatory agencies and in judicial proceedings
18 regarding the history, development, and trends in the telecommunications marketplace,
19 pertaining both to wireline and wireless (terrestrial and non-terrestrial) technologies;

1 economic and antitrust principles of competition in industries undergoing deregulation;
2 measurement of competition in telecommunications markets; the proper interpretation of
3 Long Run Incremental Cost and its role in pricing; the economic interpretation of pricing
4 and costing standards in the Telecommunications Act of 1996 ("TA96" or "the Act");
5 limitations of liability in telecommunications; Universal Service; and the pricing for
6 mutual compensation for call termination. I have also testified before state regulatory
7 commissions regarding the potential competitive effects of some of the largest
8 telecommunications mergers in the last decade. Additionally, I have submitted affidavits
9 to the Federal Communications Commission ("FCC") on a variety of topics including
10 competition in telecommunications markets, economic principles of cost analyses,
11 economic principles relevant to unbundling obligations, and empirical assessment of
12 market power. I have consulted to carriers in Europe, Australia, Israel, and Latin
13 America on interconnection and competition issues, and have consulted on issues
14 pertaining to local, long-distance, broadband, wireless, and equipment markets. I have
15 served as a testifying expert in various litigation matters involving wireless companies,
16 satellite telephony, and other communications technologies. In addition, I have consulted
17 in other industries regarding potential anticompetitive effects of bundled pricing and
18 monopoly leveraging, market definition, and entry conditions, among other antitrust
19 issues, as well as matters related to demand estimation and employee compensation and
20 contracts. I recently testified in New Jersey regarding access reform in a proceeding

1 similar to this one. In July 1995, I assumed my current position at LECG. My
2 professional qualifications are detailed in my curriculum vitae, which is attached as
3 Exhibit DJA-1.

4 **II. Context, Purpose, and Organization of This Testimony**

5 **Q: WHAT IS YOUR UNDERSTANDING OF THE SCOPE OF THIS PROCEEDING?**

6 **A:** Several years ago, the Arizona Corporation Commission (ACC) opened two dockets, a
7 generic docket to examine the costs of access services in Arizona (the "Access Charge
8 Docket"), and a docket to review the rules of Arizona's Universal Service Fund (AUSF).
9 In 2007, the Commission consolidated the two dockets in order to consider issues
10 regarding access charges and universal service simultaneously.¹ After two years of
11 discussion through workshops, comments filed by various parties, and procedural
12 conferences that yielded no specific proposals, the Commission concluded that "access
13 charges and AUSF should be reviewed to reflect the current realities in the
14 communications industry," and decided to conduct evidentiary hearings to investigate

¹ Procedural Order, *In The Matter of the Review and Possible Revision of Arizona Universal Service Fund Rules, Article 12 of The Arizona Administrative Code and In The Matter of the Investigation of the Cost of Telecommunications Access*, before the Arizona Corporation Commission, Docket Nos. RT-00000H-97-0137 and T-00000D-00-0672, September 29, 2009 (hereafter *2009 09 Procedural Order*), p. 1.

1 these issues.² According to the Procedural Order issued by Judge Rodda, the hearings
2 will cover, at the minimum, the following issues:

- 3 1. What carriers should be covered by access reform?
- 4 2. To what target level should access rates be reduced?
- 5 3. What procedures should the Commission implement to achieve the desired reduction
6 in access rates?
- 7 4. Should carriers be permitted to contract for access rates that differ from their tariffed
8 rates?
- 9 5. What revenue sources should be made available to carriers to compensate for the loss
10 of access revenues?
- 11 6. How much of access cost recovery, if any, should be shifted to end users? What
12 showing should be required for such a shift? What should be the role of "benchmark"
13 rates and how should benchmarks be set?
- 14 7. Procedurally what will be required of a carrier if it seeks a "revenue neutral" increase
15 in local rates?
- 16 8. Assuming that AUSF funds will also be used as a compensating revenue source, what
17 specific revisions (including specific recommended amendment language) to the
18 existing rules are needed to allow use of AUSF funds for that purpose?
- 19 9. Which carriers should be eligible for AUSF support?
- 20 10. What should be supported by AUSF? Access replacement only? High cost loops?
21 Line extensions? Centralized administration and automatic enrollment for Lifeline
22 and Link-up?
- 23 11. What should be the basis of AUSF contributions and what should be the structure of
24 any AUSF surcharge(s)?
- 25 12. Any other specific revisions to the AUSF rules.³

² 2009 09 Procedural Order, p. 4.

³ 2009 09 Procedural Order, pp. 4-5. Parties may also address "additional matters that they believe are important to the Commission's investigation."

1 Q: **PLEASE EXPLAIN THE PURPOSE AND ORGANIZATION OF YOUR DIRECT**
2 **TESTIMONY.**

3 A: The purpose of my direct testimony is to address Issues 1-3 and 5-6 in the Procedural
4 Order issued by Judge Rodda on September 29, 2009. First, under Issues 1 and 2, I
5 explain, on the basis of economic principles and analysis, the harmful effects the current
6 switched access charge regime is having on Arizona consumers and on the competitive
7 process. I explain that reducing the currently excessive intrastate switched access rates in
8 Arizona will promote the objectives of Arizona telecommunications policy by:

- 9 (i) enhancing the welfare of consumers of telecommunications services in
10 Arizona;
11 (ii) decreasing regulatory impediments to competitive neutrality between
12 technologies;
13 (iii) reducing incentives for wasteful arbitrage; and
14 (iv) improving the efficiency of investment incentives.

15 Reducing intrastate access rates to interstate levels will therefore serve the public interest.

16 I then explain, under Issues 3, 5, and 6, that access reductions are properly seen as part of
17 a holistic approach to access reform that must allow local exchange carriers ("LECs") an
18 opportunity to recover access revenues that would be forgone on rate-regulated lines as a
19 result of the policy change. These revenue opportunities can be provided in the form of
20 increased retail prices alone or in combination with universal service support funds.

1 Each solution has merits and demerits, which I explain in hopes of assisting the
2 Commission to develop a sound, holistic policy approach to access reform that advances
3 social welfare in Arizona.

4 My testimony is organized as follows: Section III provides a summary of my
5 conclusions. Section IV presents a brief history of the telecommunications policies in the
6 U.S. that led to the current distorted access price regime, and the reforms adopted at the
7 federal level to partially address these distortions. Section V describes the existing
8 switched access regime in Arizona and how the intrastate switched access rates paid by
9 wireline interexchange carriers ("IXCs") to LECs in Arizona differ from interstate
10 switched access rates, as well as from the rates paid by CLECs for local call termination
11 and from the rates paid by wireless companies for call termination, all of which functions
12 are materially the same as intrastate switched access services provided to IXCs. I also
13 describe the actions that have already been taken in many other states to reduce intrastate
14 access charges. In Section VI, I describe the economic harms to consumers, competition,
15 and investment that result from the existing asymmetries and inconsistencies of the
16 current access regime, as well as the perverse incentives for regulatory arbitrage created
17 by the distortions of the existing switched access regime. I explain that reducing
18 intrastate access charges to parity with interstate access rates would benefit consumers,
19 competition and investment, and reduce incentives for carriers to pursue wasteful and

1 opportunistic arbitrage opportunities. Section VII explains why, in light of the forgoing
2 analysis, the Commission should order incumbent local exchange carriers ("ILECs") to
3 decrease intrastate access rates to interstate levels, and order competitive local exchange
4 carriers ("CLECs") to cap their rates at the level of the ILEC with which the CLEC
5 competes. I explain that this policy will bring intrastate access charges in Arizona closer
6 to the ILECs' costs, thereby enhancing economic efficiency. I also explain the unique
7 regulatory and market characteristics of switched access that endow all LECs, including
8 CLECs, with market power over access to their own customers, necessitating the
9 proposed regulatory intervention. In Section VIII, I explain that access rate reductions
10 must be seen as part of a holistic and revenue-neutral approach that allows rate-regulated
11 carriers to recover the forgone access revenues on price-capped lines. Section IX
12 summarizes the benefits to consumers and the economy from reforming intrastate access
13 rates to interstate levels.

14 **III. Summary of Conclusions**

15 **Q: DR. ARON, PLEASE SUMMARIZE THE CONCLUSIONS OF YOUR DIRECT**
16 **TESTIMONY.**

17 **A:** The Commission should order all local exchange companies in Arizona to decrease their
18 intrastate switched access rates. ILECs should reduce their rates to the levels and
19 structure of their corresponding interstate switched access rates. Each CLEC should

1 reduce its intrastate access charge levels and structure to that of the ILEC with whom it
2 competes in a specific area. Doing so would bring intrastate access rates to more
3 efficient levels and bring them closer into line with the fees charged by the same LECs
4 providing the same functionality to competitors using other technologies. Bringing the
5 rates closer to the ILECs' interstate charges, and bringing them more into alignment with
6 rates charged to intermodal competitors and to other wireline providers for the same
7 functionality, benefits consumers and competition and would promote the public interest.

8 Current intrastate access rates—the rates charged by wireline LECs to wireline IXC's for
9 originating and terminating long distance telephone calls to their customers—are far
10 above the rates that the same LECs charge to originate and terminate interstate calls, even
11 though the functionality provided is the same. The LECs' intrastate switched access rates
12 are even farther above the rates that the same LECs charge for the same functionality
13 provided to CLECs to terminate local calls, and to mobile wireless service providers to
14 terminate most intrastate wireless calls.

15 Figure 1 shows the average call origination and termination rates assessed by ILECs
16 Qwest, Verizon and Arizona Local Exchange Carrier Association ("ALECA") members,
17 as well as CLECs Cox and Integra, in Arizona.

Figure 1

Average Charges for Call Termination Services in Arizona

[BEGIN HIGHLY CONFIDENTIAL INFORMATION]



[END HIGHLY CONFIDENTIAL INFORMATION]

The chart illustrates the disparities—which can only be described as huge—between the rates that LECs charge for the same functionality of call termination depending on the regulatory jurisdiction governing the call. Intrastate access rates in Arizona are multiples

1 of the rates charged by the same LECs for the same functionality if the call is
2 jurisdictionally interstate, local or wireless.

3 For example, consider a customer in Phoenix who subscribes to Qwest for local services
4 and to AT&T for long distance services. If that customer were to make a ten-minute call
5 to a Verizon customer in Los Angeles, AT&T would pay Verizon a bit over [BEGIN
6 HIGHLY CONFIDENTIAL INFORMATION] [END HIGHLY
7 CONFIDENTIAL INFORMATION] in interstate access charges to terminate the call,
8 and would pay Qwest approximately [BEGIN CONFIDENTIAL INFORMATION]
9 [END CONFIDENTIAL INFORMATION] in interstate access charges to
10 originate the call. Hence, AT&T would pay approximately [BEGIN HIGHLY
11 CONFIDENTIAL INFORMATION] [END HIGHLY CONFIDENTIAL
12 INFORMATION] in access charges on that call. However, if the same customer were
13 to make a ten-minute intrastate call from Phoenix to a Verizon customer in Parker,
14 Arizona, AT&T would pay Verizon approximately [BEGIN HIGHLY
15 CONFIDENTIAL INFORMATION] [END HIGHLY CONFIDENTIAL
16 INFORMATION] in intrastate access charges to terminate the call, and would pay
17 Qwest approximately [BEGIN CONFIDENTIAL INFORMATION] [END
18 CONFIDENTIAL INFORMATION] in intrastate access charges to originate the call.
19 Hence, for the in-state call, AT&T would pay over [BEGIN HIGHLY

1 **CONFIDENTIAL INFORMATION]** [REDACTED] **[END HIGHLY CONFIDENTIAL**
2 **INFORMATION]** in access charges. All together, AT&T would pay over ten times as
3 much in access charges for the intrastate call, even though Qwest would be providing the
4 same functionality to originate the call, and Verizon would be providing the same
5 functionality to terminate the call in either case. Moreover, if the caller in Phoenix used
6 her cell phone instead to call the same party in Parker, the wireless provider would pay
7 only **[BEGIN HIGHLY CONFIDENTIAL INFORMATION]** [REDACTED] **[END**
8 **HIGHLY CONFIDENTIAL INFORMATION]** to Verizon to terminate the call (and
9 no intercarrier fees to originate the call).

10 Decreasing intrastate access charges would directly benefit consumers because economic
11 principles dictate and the evidence across 50 states shows that when access fees go down,
12 retail long distance prices go down as well. In fact, numerous states have already
13 reformed ILEC intrastate access rates and targeted intrastate access rates to equal, or
14 “mirror,” interstate access rates, as AT&T proposes here. At least 16 states have
15 imposed caps on CLEC intrastate access rates. Based on the historical relationship across
16 50 states between AT&T’s intrastate access charges and its intrastate long distance prices
17 over the last several years, the data indicate that the proposed access reform would lead
18 to a decrease of 19 to 42 percent in AT&T’s average intrastate long distance price in
19 Arizona.

1 Moreover, the highly disparate access rates in the current system harm competition and
2 distort investment by creating an artificial, regulatory-induced competitive disadvantage
3 for wireline long distance providers as compared to their intermodal long distance
4 competitors. Decreasing intrastate access rates to interstate levels would not eliminate
5 the disparities across technology platforms but would significantly diminish them,
6 creating a more level playing field and permitting a greater degree of competition on the
7 merits, encouraging investment that better reflects the relative efficiencies of different
8 technologies and service providers, and reducing incentives for wasteful and
9 opportunistic arbitrage.

10 The harms from the current regulatory access regime in Arizona can be summarized to
11 include the following:

- 12 • Consumers pay excessive prices for wireline intrastate toll services and are unduly
13 discouraged by these uneconomically high prices from using and enjoying long
14 distance service on the wireline network;
15
- 16 • Consumers are unduly discouraged from making wireline long distance calls in favor
17 of using other communications alternatives, even where consumers might prefer the
18 service characteristics of a wireline call;
19
- 20 • Competition between technologies is distorted by an access regime that permits other
21 providers using alternative technologies to pay substantially lower rates for materially
22 identical functionality as that provided to traditional wireline carriers at much higher
23 rates, and that artificially disadvantages IXCs vis-à-vis other communications options
24 that avoid the public switched telephone network ("PSTN") (and regulated
25 interconnection charges) entirely;
26

- 1 • The incentive and ability of wireline long distance providers to invest in the provision
2 of wireline long distance services is reduced because consumers are unduly
3 discouraged from using those services;
4
- 5 • Arbitrage opportunities are created by regulatory distortions under which, for
6 example, call-pumping schemes exploit access payers, and resources are wasted on
7 enforcing traffic distinctions that have no economic basis but have significant pricing
8 implications under the current system.
9

10 Existing intrastate access rates perpetuate an outmoded regulatory policy of the
11 monopoly era by which LEC services were subsidized by long distance services. While
12 access reform is sorely overdue in Arizona, it is appropriate that reform of intrastate
13 access policy be viewed holistically, acknowledging the historical policy quid pro quo by
14 which access rates subsidized below-cost retail prices for local services. A holistic
15 policy reform will therefore provide an opportunity for LECs to recover the access
16 revenues forgone on price-regulated lines through some combination of (i) increased
17 retail prices on price-regulated lines and (ii) explicit support from the state universal
18 fund.

19 Providing LECs the opportunity to recover the lost access revenues via retail price
20 increases would be the most economically efficient means of recovering those revenues,
21 and would best promote competition and efficient investment. If, however, the
22 Commission finds that the price increase necessary to recover all access revenues that
23 would be forgone due to the access rate reductions is untenable for universal service

1 reasons, a smaller price increase could be allowed and the remaining revenue could be
2 recovered in universal service support. This method of revenue recovery respects the
3 policy concern for limiting prices to "affordable" levels, albeit at the cost of some
4 economic efficiency. At the same time, allowing cost recovery by providing universal
5 service support imposes support burdens on customers who must pay for those subsidies,
6 including some customers with below-average income. In light of the broad availability
7 of wireless voice services and broadband-based voice services in the marketplace today,
8 in assessing an appropriate benchmark the Commission would be well-served to
9 scrutinize old assumptions about whether allowing retail prices to rise to fully recover the
10 forgone access revenues would be likely to have any genuine effect on telephone
11 penetration in Arizona.

12 Regardless of the method of revenue recovery chosen by the Commission, the
13 Commission should recognize that today's convoluted patchwork structure of
14 access/interconnection rates needs to be reformed to decrease intrastate access rates in
15 Arizona to interstate levels so that:

- 16 • different technologies and companies can compete more closely on their
17 merits;
- 18 • consumers can benefit from lower, more cost-based prices for wireline long
19 distance telephony;

- consumers can choose among providers based more closely on the relative value provided;
- wasteful arbitrage activities are limited; and
- consumers in Arizona can more fully enjoy the benefits of all modern communications technologies.

IV. The Legacy Access Regime is No Longer Viable (Issues 1 and 2)

A. Switched Access Charges Were Originally Set to Provide "Implicit Subsidies" for Below-Cost Local Service Prices

Q: WHAT IS "SWITCHED ACCESS"?

A: Switched access is the service that a LEC provides to an IXC to transport the portion of the IXC's call that begins or terminates on the LEC's facilities. Consider, for example, a customer who subscribes to the long distance service of AT&T, and the local exchange service of Cox. Suppose that the customer makes a long distance call to a friend who receives local exchange service from Qwest. AT&T, the IXC in this example, does not have a direct connection to either customer but its network is interconnected with the local exchange facilities of both Cox and Qwest. When that call is dialed, it will travel over Cox's communications path, or "loop," from the calling customer's home to Cox's switch. Cox's switch will determine that the call is to be sent to the network of AT&T, the customer's long distance carrier, and it will route the call to Cox's transport facilities

1 that connect with AT&T's network. From that point, AT&T will transport the call to a
2 point of interconnection with Qwest near the called party, where it will hand off the call
3 to Qwest for delivery to the called party. Cox's delivery and handoff of the call from the
4 calling customer's premises to AT&T's point of interconnection is called originating
5 switched access service, and Qwest's receipt and delivery of the call to the called party is
6 called terminating switched access service. On both sides, the access supplier provides
7 the connection to an end-user.

8 Although the access services are identical regardless of the distance between the parties,
9 the price that AT&T pays for those services is determined by whether the calling and
10 called parties are in the same state (in which case intrastate switched access charges
11 would apply) or different states (in which case interstate switched access charges would
12 apply).

13 Consider another scenario. Suppose the customer served by Cox makes a *local* call to a
14 neighbor who is served by Qwest. In that case, Cox must transport the call to Qwest's
15 network for delivery to the called party. The terminating function that local exchange
16 company Qwest provides to local exchange company Cox is the same in all material
17 respects as the terminating function that Qwest provided to long distance provider AT&T
18 in the previous scenario. The termination service provided by Qwest in this scenario has

1 the same economic characteristics as in the first scenario, but for historic reasons goes by
2 a different name and is priced under a different regime.

3 **Q: WHAT ARE SWITCHED ACCESS CHARGES?**

4 A: "Switched access charges" (or, in shorthand, "access charges") is the regulatory term of
5 art applied to the prices that wireline local telephone companies charge to wireline long
6 distance providers to furnish switched access service. Access charges are a payment
7 from one company to another (i.e., they are "intercarrier" charges) that derive from the
8 fact that networks are interconnected and a call may have to traverse more than one
9 carrier's network to be completed. When the terminating functionality is provided by
10 one LEC to another LEC under a local area calling arrangement, the call-termination
11 functionality provided is the same as the functionality provided to terminate a long
12 distance call, but the intercarrier fee paid is called "reciprocal compensation."

13 For purposes of this testimony, I will use the term "access/interconnection regime" to
14 mean the entire set of regulator-approved charges that wireline LECs charge to other
15 carriers—wireline, wireless, incumbents, and CLECs—for the function of originating or
16 terminating calls, whether local or long distance, intrastate or interstate. In some cases,
17 these charges are set by the FCC and in other cases they are set or approved by state

1 regulators.⁴ The Commission has control over only a part of the overall
2 access/interconnection regime that affects carriers and customers in Arizona, and it is
3 important in this proceeding for the Commission to understand the context of the rates
4 under its supervision in the broader access/interconnection regime and the effect of that
5 regime on consumers and the state's retail telecommunications marketplace.

6 **Q: YOU REFERRED TO INCUMBENT WIRELINE PROVIDERS, CLECS, AND**
7 **WIRELESS PROVIDERS. DO ALL OF THESE KINDS OF COMPANIES USE**
8 **SWITCHED ACCESS SERVICE, OR THE EQUIVALENT FUNCTIONALITY,**
9 **PROVIDED BY WIRELINE LOCAL TELEPHONE COMPANIES?**

10 **A:** Yes. Though the terminology "switched access service" is used to refer to wireline
11 LECs' origination and termination of wireline long distance calls, the same
12 interconnection functionality is used by all of these kinds of companies. The service may
13 fall under different regulatory categories and go by different names, but all of these
14 companies use the comparable service, because any time one of their customers calls a
15 customer of a wireline local telephone company it must be handed off to the LEC serving
16 the called party so that the latter LEC can deliver the call to the called party. The current
17 access/interconnection regime applies to all these different kinds of providers and calls
18 under a mosaic of mismatched regulatory policies and rules. This results in a broad range
19 of different prices that are charged for the same functionalities, which in turn derives

⁴ In some states there appear to be no specific rules governing intrastate access rates charged by CLECs, though their interstate rates are governed and capped by the FCC.

1 from a regulatory history that has not been reformed in step with the technological and
2 competitive changes in the industry.

3 **Q: CAN YOU PROVIDE AN EXAMPLE OF THE PATCHWORK REGULATORY**
4 **APPLICATION OF ACCESS CHARGES THAT YOU ARE DESCRIBING?**

5 **A:** Yes. Consider a customer who purchases local exchange service from Qwest and long-
6 distance service from AT&T. Every time that customer places a long distance call on her
7 wireline phone, AT&T, not Qwest, charges the customer for the call. However, Qwest
8 handles part of the call—specifically, the part that begins at the caller's location and ends
9 at AT&T's network. Qwest takes such calls from the calling customer's home over
10 Qwest's facilities to Qwest's switch at Qwest's local office, and then to Qwest's
11 interconnection point with AT&T's network, while holding capacity open on its own
12 switch and other facilities for the duration of the call. As I have described, Qwest is
13 entitled, as a matter of current regulatory policy, to charge AT&T for that functionality to
14 recover the costs that Qwest incurs. The fee is known as the originating switched access
15 charge.

16 The functionality provided by Qwest is the same, however, regardless of whether the
17 called party is located in the next town, the next state, or another country. Qwest
18 provides the dial tone, determines where the call should go, and brings it to the
19 interconnection point with AT&T's network. It is AT&T's responsibility to transport the

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1 call to the carrier serving the called party who might be a few or several thousands of
2 miles away.

3 As an analogy, consider the job of a taxicab driver who picks up passengers at home and
4 drives them to Phoenix's Sky Harbor Airport. The driver's job is the same whether the
5 passenger is going to catch a flight to Tucson, New York, or Paris, and one would expect
6 the taxi fare to be the same. The current access charge system in the United States,
7 however, is akin to the taxicab driver asking the passenger where she is flying to once
8 she gets to the airport, and charging a much higher fare if she is flying to Tucson than if
9 she is flying to New York or Paris.

10 Similarly, on the terminating end, when an AT&T long distance customer in New York
11 places a call to a Qwest local customer in Arizona, AT&T hands that call off to Qwest in
12 Arizona for final delivery to the customer. Qwest's functions in terminating the call are
13 the same, regardless of whether the long distance call comes in from New York or a
14 neighboring town in Arizona—just as a taxi driver's functions in taking a passenger
15 home from the airport are the same regardless of where the passenger flew in from. In
16 fact, Qwest's functions are the same even for a local call from a next door neighbor
17 whose local provider is not Qwest. Because of the idiosyncrasies of intercompany
18 regulation and different jurisdictions associated with different kinds of calls and different
19 carriers, however, the price that Qwest charges for that service is vastly different in

1 Arizona depending on where that call originated. In fact, under the current anomalous
2 rules, the price Qwest charges AT&T to terminate a call is substantially higher if it comes
3 from a neighboring town in Arizona than if the call comes from New York.

4 **Q: HOW WAS THE ACCESS CHARGE REGIME DEVELOPED?**

5 A: Before the divestiture of the "Baby Bells" from AT&T in 1984, there was no such thing
6 as "access charges." In the monopoly era of the late 1940s when long distance was still
7 viewed as a luxury, the FCC and state regulators established a policy that imposed cross-
8 subsidy obligations on long distance users to encourage universal subscription to the
9 public switched telephone network by holding local service prices below cost, a policy
10 known as "universal service." These cross-subsidies were implemented through a
11 "separations and settlements" accounting process under which some of the costs of
12 providing customers with access to the local telephone network were attributed to the
13 long distance network and built into the (regulator-set) retail prices of long distance
14 service.⁵ While there is a disagreement as to their exact magnitude, there is a consensus

⁵ Paul W. MacAvoy, *THE FAILURE OF ANTITRUST AND REGULATION TO ESTABLISH COMPETITION IN LONG-DISTANCE TELEPHONE SERVICE*, (Cambridge, Massachusetts: MIT Press, 1996), pp. 8-11; and Stephen Breyer, *REGULATION AND ITS REFORM*, (Cambridge, Massachusetts: Harvard University Press, 1982) (hereafter *Breyer 1982*), pp. 296-298. The cost allocation formulas were known as "separations," and the revenue side of the cost allocation formulas were known as "settlements" when paid to an independent telephone company and "divisions of revenues" when paid to AT&T affiliates; Gerald W. Brock, *TELECOMMUNICATION POLICY FOR THE INFORMATION AGE: FROM MONOPOLY TO COMPETITION*, (Cambridge, Massachusetts: Harvard University Press, 1994) (hereafter *Brock 1994*), pp. 66-70.

1 that the separations and settlements process produced retail prices that contained
2 significant embedded cross-subsidies from long-distance to local services.⁶

3 Upon the AT&T divestiture in the mid-1980s, the separations and settlements process
4 was abolished and replaced with an access charge regime that continued the cross-
5 subsidy policy.⁷ In the access charge regime, long distance companies are required to
6 pay a fee (the access charge) to the local exchange company or companies serving the
7 calling and called customers of a long distance call for the functionality of handling the
8 call at the originating and terminating ends.⁸

9 In designing its new system of regulated interstate access charges, the FCC
10 acknowledged that a system of cross-subsidies was incompatible with competition and,

⁶ Jerry Hausman, Timothy Tardiff, and Alexander Belinfante, "The Effects of the Breakup of AT&T on Telephone Penetration in the United States," *American Economic Review* 83, no. 2, (May 1993), p. 178; Larry Blank, David L. Kaserman, and John W. Mayo, "Dominant Firm Pricing with Competitive Entry and Regulation: The Case of IntraLATA Toll," *Journal of Regulatory Economics* 14, (1998), pp. 37, 39; David L. Kaserman, John W. Mayo, and Joseph E. Flynn, "Cross-Subsidization in Telecommunications: Beyond the Universal Service Fairy Tale," *Journal of Regulatory Economics* 2, (1990), pp. 232-235; Robert W. Crandall and Leonard Waverman, *TALK IS CHEAP: THE PROMISE OF REGULATORY REFORM IN NORTH AMERICAN TELECOMMUNICATIONS*, (Washington D.C.: The Brookings Institute, 1995), pp. 34-35; Alfred E. Kahn, "The Road to More Intelligent Telephone Pricing," *Yale Journal on Regulation* 1, (Spring 1984), pp. 140-144; and Peter Temin, "Cross Subsidies in the Telephone Network after Divestiture," *Journal of Regulatory Economics* 2 (1990), pp. 349-362.

⁷ *Brock* 1994, pp. 180, 186.

⁸ Order on Remand and Report and Order and Further Notice of Proposed Rulemaking, *In the Matter of High-Cost Universal Service Support and Federal-State Joint Board on Universal Service et al.*, before the Federal Communications Commission, FCC 08-262, (released November 5, 2008), (hereafter *2008 NPRM*), Appendix A, ¶ 165.

1 hence, it sought to implement procedures that reduced or eliminated them.⁹ The FCC
2 established access charges that significantly exceeded their incremental costs, but stated
3 that it planned to reduce those access charges gradually over time.¹⁰

4 Some efforts were made in the 1980s and 1990s to reform access rates, but per-minute
5 access rates remained—to use the FCC’s characterization—“high.”¹¹ At the time of
6 divestiture in 1984, the interstate per-minute switched access rate was 17.26¢, and by
7 1996 it had declined substantially, but to the still very high rate of 6.16¢.¹² In fact, these
8 relatively high switched access rates created an arbitrage opportunity by which new
9 entrants built direct connections to business locations so that these business customers
10 could bypass switched access charges by connecting directly to their long distance
11 providers and avoiding the LEC entirely when they made long distance calls.¹³

12 **B. Recognizing That the Old System of Implicit Subsidies Can No Longer Be**
13 **Sustained, the FCC Has Adopted Significant Reforms**

⁹ The FCC concluded that “[a]rtificial pricing structures, while perhaps appropriate for use in achieving social objectives under the right conditions, cannot withstand the pressures of a competitive marketplace.” See, Memorandum Opinion and Order, *In the Matter of MTS and WATS Market Structure*, before the Federal Communications Commission, FCC 83-356, (released August 22, 1983), ¶ 7.

¹⁰ 2008 NPRM, Appendix A, ¶¶ 165-166.

¹¹ 2008 NPRM, Appendix A, ¶¶ 167-168.

¹² “Trends in Telephone Service,” Federal Communications Commission, Industry Analysis and Technology Division Wireline Competition Bureau, August 2008, (hereafter *2008 FCC Trends in Telephone Service*), Table 1.2.

¹³ 2008 NPRM, Appendix A, ¶ 168; and Peter W. Huber, Michael K. Kellogg, and John Thorne, *The Geodesic Network II: 1993 Report on Competition in the Telephone Industry*, pp. 2.24-2.52.

1 Q: DID THE FCC ADOPT SIGNIFICANT REFORMS TO INTERSTATE
2 SWITCHED ACCESS CHARGES FOLLOWING THE ENACTMENT OF THE
3 TELECOMMUNICATIONS ACT OF 1996 ("TA96")?

4 A: Yes. The purpose of TA96 was to open local exchange markets to competition.¹⁴ The
5 inherent friction that already existed between a cross-subsidy policy and competition in
6 long distance markets was magnified by the complete incompatibility between a cross-
7 subsidy policy and competition in local exchange markets. TA96 therefore was the final
8 straw in rendering the legacy system of implicit cross-subsidization of local service from
9 long distance providers unworkable in the long term. Congress recognized, in fact, that
10 the implicit subsidies built into the old system in which retail prices for basic local
11 service were set below cost to encourage local subscribership while access rates were set
12 well above cost in order to subsidize the below-cost retail prices for local service were
13 not sustainable in a competitive marketplace. Congress, therefore, directed the FCC to
14 eliminate or replace implicit subsidies with explicit subsidies thereby moving all
15 interstate access rates towards cost-based levels.¹⁵

¹⁴ Telecommunications Act of 1996, Preamble; and, First Report and Order, *In the Matter of Implementation of the Local Competition Provisions in the Telecommunications Act of 1996 and Interconnection between Local Exchange Carriers and Commercial Mobile Radio Service Providers*, before the Federal Communications Commission, FCC 96-325, (released August 8, 1996), (hereafter *1996 Interconnection Order*), ¶ 3.

¹⁵ 2008 NPRM, Appendix A, ¶ 169.

1 Q: **WHY IS A CROSS-SUBSIDY POLICY NO LONGER VIABLE IN TODAY'S**
2 **MARKET PLACE?**

3 A: As I explained earlier, the original purpose of legacy cross-subsidy policies was to keep
4 prices for residential local service artificially low, even if that meant keeping them below
5 their true economic cost, to encourage universal subscription to telephone service. A key
6 problem with that policy, however, is that it is counterproductive to the process of
7 competition. In the long run, you can have efficient competition, or you can have
8 implicit cross-subsidies built into regulated prices, but you cannot have both. Efficient
9 competition is impeded and innovative investment is discouraged if retail prices are held
10 below cost and cannot respond to market conditions (such as changes in production costs
11 or demand).¹⁶

12 Moreover, not only are cross subsidies destructive to efficient competition, but
13 competition ultimately undermines the cross subsidies. As excessive access rates keep
14 wireline long distance prices higher than they would otherwise be, consumers are
15 encouraged to switch to alternatives, such as wireless calls (which are not subject to the
16 same level of termination costs, as I will explain shortly) and other options that bypass
17 the PSTN entirely, such as computer-to-computer calling, social networking sites, or
18 instant messaging. The decreased usage of wireline long distance service in turn causes

1 access revenues to decrease, drying up the very source of subsidy that the access rates
2 were originally designed to provide. According to information compiled by the FCC,
3 reporting ILECs' interstate interLATA billed access minutes carried by IXCs declined
4 from a peak of 535.0 billion in 2000 to 372.0 billion in 2006—the most recent year with
5 available information—a decline of 30 percent in just six years. In that same time period,
6 intrastate interLATA minutes declined by about 33 percent, from 257.3 billion to 171.1
7 billion.¹⁷ Hence, a system of subsidizing local exchange companies via access charges is
8 not sustainable in the presence of competition that is severely eroding the source of
9 subsidies.

10 **Q: HAS THE FCC INSTITUTED ACCESS REFORM IN LIGHT OF THE**
11 **MANDATES OF TA96?**

12 **A:** Yes. In response to the mandate of TA96 to eliminate or replace implicit subsidies with
13 explicit subsidies and move all interstate access rates towards cost-based levels, the FCC
14 implemented significant access reforms in May 1997, May 2000, and November 2001
15 with the releases of its *Access Charge Reform Order*, *CALLS Order*, and *MAG Order*,
16 respectively. The *Access Charge Reform Order* established rules that required the
17 structure of access charges to more closely reflect cost-causation. The rules reduced the
18 usage-sensitive (per-minute) interstate switched access rates by removing fixed, non-

¹⁶ See Debra J. Aron and David E. Burnstein, "Regulatory Policy and the Reverse Cellophane Fallacy," June 1, 2008, available at SSRN: <http://ssrn.com/abstract=1171292>, forthcoming, *Journal of Competition Law & Economics*.

1 traffic sensitive costs from these charges and requiring incumbent LECs to recover these
2 costs through flat-rated charges to their end-user customers.¹⁸ The FCC acknowledged
3 that these reforms would not “remove all implicit support from all access charges
4 immediately,” however, and concluded that a process of gradually reducing interstate
5 access charges to cost over time was warranted.¹⁹ Over a three-year period, the per-
6 minute interstate switched access rate declined by over half, from 6.04¢ in January 1997
7 to about 2.85¢ in January 2000.²⁰

8 The FCC and the industry nevertheless recognized that further reductions to switched
9 access charges were warranted. The *CALLS Order* implemented further reductions to
10 price cap ILECs’ interstate switched access rates by adopting a proposal set forth by a
11 consortium of local and long-distance providers.²¹ The *CALLS Order* reduced ILECs’
12 interstate switched access charges by reducing local switching and other traffic-sensitive
13 rate elements. The FCC ordered large ILECs, other price cap LECs, and rural price cap
14 ILECs to reduce their average traffic-sensitive rates to 0.55¢, 0.65¢, and 0.95¢ per

¹⁷ 2008 FCC Trends in Telephone Service, Table 10.2.

¹⁸ First Report and Order, *In the Matter of Access Charge Reform and Price Cap Performance Review for Local Exchange Carriers et al.*, before the Federal Communications Commission, FCC 97-158, (released May 16, 1997), (released May 16, 1997), (hereafter *1997 Access Reform Order*), ¶ 6.

¹⁹ *1997 Access Reform Order*, ¶ 9.

²⁰ 2008 FCC Trends in Telephone Service, Table 1.2.

²¹ Sixth Report and Order in CC Docket Nos. 96-262 and 94-1, Report And Order in CC Docket No. 99-249, Eleventh Report and Order in CC Docket No. 96-45, *In the Matter of Access Charge Reform and Price Cap Performance Review for Local Exchange Carriers et al.*, before the Federal Communications Commission, FCC 00-193, (released May 31, 2000), (hereafter *FCC CALLS Order*), ¶¶ 1-3. By “price cap ILECs,” I mean ILECs that are subject to price cap regulation by the FCC.

1 minute, respectively, and established a new explicit universal support fund to help local
2 exchange carriers offset the reduction in switched access charges received.²²

3 In the *MAG Order*, the FCC implemented similar reforms to the access prices that could
4 be charged by ILECs subject to rate-of-return regulation.²³ As with the *CALLS Order*, the
5 *MAG Order*'s reforms were "designed to bring the American public benefits of
6 competition and choice by rationalizing the access rate structure and driving per-minute
7 rates towards lower, more cost-based levels."²⁴ The *MAG Order* provided for reductions
8 in per-minute charges for rate-of-return ILECs and created a universal service support
9 mechanism to replace implicit support with explicit support.²⁵ Interstate access rates
10 achieved as a result of the *CALLS Order* and the *MAG Order* are, with minor
11 modifications, the interstate access rates in effect today.²⁶

²² *FCC CALLS Order*, ¶¶ 30, 32, 56, 162. Qwest and Verizon are subject to the 0.55¢ rate in Arizona. See, *FCC CALLS Order*, ¶ 144; Federal Communications Commission, "Carrier Filing History," http://www.fcc.gov/wcb/armis/carrier_filing_history; and Federal Communications Commission, "Verizon GTE Corporation (GTTC)," http://www.fcc.gov/wcb/armis/carrier_filing_history/COSA_History/gtcc.htm.

²³ Second Report and Order and Further Notice of Proposed Rulemaking in CC Docket No. 00-256, Fifteenth Report and Order in CC Docket No. 96-45, and Report and Order in CC Docket Nos. 98-77 and 98-166, *In the Matter of Multi-Association Group (MAG) Plan for Regulation of Interstate Services of Non-Price Cap Incumbent Local Exchange Carriers and Interexchange Carriers and Federal-State Joint Board on Universal Service et al.*, before the Federal Communications Commission, FCC 01-304 (released November 8, 2001), (hereafter *MAG Order*).

²⁴ *MAG Order*, ¶ 1.

²⁵ *MAG Order*, ¶¶ 15.

²⁶ 2008 *FCC Trends in Telephone Service*, Table 1.2, and pp. 1-1, 1-2.

1 Q: **DID THE FCC CONCLUDE THAT REDUCING INTERSTATE ACCESS RATES**
2 **WOULD BENEFIT CONSUMERS?**

3 A: Yes. The FCC concluded in the *CALLS Order* that the mandated restructuring and
4 reduction of access charges would produce lower long distance prices to consumers,
5 resulting in "significant consumer benefits."²⁷ The FCC drew similar conclusions in the
6 *MAG Order*, as mentioned above.²⁸

7 Q: **HAS THE FCC ALSO SET LIMITS ON CLECS' INTERSTATE ACCESS**
8 **RATES?**

9 A: Yes. In 2001, the FCC concluded that CLECs have market power in the provision of
10 switched access services and required that CLECs' interstate access rates in any
11 geographic area be capped at the interstate access rates of the ILEC in that area.²⁹
12 Although the FCC identified those caps as an "interim measure" at the time, the FCC has
13 not rescinded those caps and at least as recently as 2005, in its *Intercarrier Compensation*
14 *Reform FNPRM*, has reiterated its conclusion (correctly, as I will explain in Section VII)
15 that terminating access is a monopoly.³⁰

²⁷ *FCC CALLS Order*, ¶¶ 28, 35.

²⁸ See also *MAG Order*, ¶ 11.

²⁹ Seventh Report and Order and Further Notice of Proposed Rulemaking, *In the Matter of Access Charge Reform and Reform of Access Charges Imposed by Competitive Local Exchange Carriers*, before the Federal Communications Commission, FCC 01-146, (released April 27, 2001), (hereafter *CLEC Access Charge Reform Order*), ¶¶ 29, 31, 52.

³⁰ See, for example, Further Notice of Proposed Rulemaking, *In the Matter of Developing a Unified Intercarrier Compensation Regime*, before the Federal Communications Commission, FCC 05-33, (released March 3, 2005), (hereafter *Intercarrier Compensation Reform FNPRM*), ¶ 24. Regarding originating access, the FCC has not indicated any retreat from its 2001 conclusion that originating access is a monopoly service (See, *CLEC*

1 Q: HAS THE FCC RECOGNIZED THAT THE CURRENT ACCESS CHARGE AND
2 INTERCONNECTION REGIME REQUIRES FURTHER REFORMS IN LIGHT
3 OF THE COMPETITIVE DEVELOPMENTS IN THE INDUSTRY?

4 A: Yes. The FCC acknowledged shortly after the release of the 2000 *CALLS Order* that a
5 comprehensive, unified, and competitively neutral regime was called for.³¹ The FCC
6 stated in a 2001 Notice of Proposed Rulemaking that the ad hoc nature of intercarrier
7 compensation is an impediment to the development of competition,³² and observed that
8 “[i]nterconnection arrangements between carriers are currently governed by a complex
9 system of intercarrier compensation regulations... [that] treat different types of carriers
10 and different types of services disparately, even though there may be no significant
11 differences in the costs among carriers or services.”³³ The FCC has since received
12 proposals, opened a subsequent rulemaking³⁴ and, according to the FCC, “compiled an
13 extensive record over the past seven years.”³⁵ However, despite passing the eight-year
14 mark, the FCC has yet to issue an order on comprehensive reform.

Access Charge Reform Order, ¶ 29), and as recently as 2008 then-chairman Martin proposed eliminating originating access charges entirely. See, 2008 *NPRM*, Appendix A, ¶ 229.

³¹ Notice of Proposed Rulemaking, *In the Matter of Developing a Unified Intercarrier Compensation Regime*, before the Federal Communications Commission, FCC 01-132, (released April 27, 2001), (hereafter 2001 *NPRM*), ¶¶ 1-2.

³² 2001 *NPRM*, ¶¶ 11-18.

³³ 2001 *NPRM*, ¶ 5.

³⁴ Further Notice of Proposed Rulemaking, *In the Matter of Developing a Unified Intercarrier Compensation Regime*, before the Federal Communications Commission, FCC 05-33, (released March 3, 2005).

³⁵ 2008 *NPRM*, Appendix A, ¶ 187.

1 The FCC continues, nevertheless, to articulate the need for access reform and the
2 detrimental effect that the current regime of ad hoc, excessive, and mismatched rates has
3 on competition and consumers. On November 5, 2008, the FCC sought comments on an
4 intercarrier compensation reform proposal drafted by then-FCC Chairman Martin. The
5 Martin proposal articulates the following shortcomings with the *status quo* intercarrier
6 compensation regulations:

7 The differences in existing intercarrier compensation regimes impose
8 significant inefficiencies on users and distort carriers' investment
9 incentives, which can result in losses of billions of dollars in consumers
10 and producers surplus. Possibly more important, these legacy regulatory
11 regimes pose an obstacle to the transition to an all-IP broadband world.
12 Because carriers currently can receive significant revenues from charging
13 above-cost rates to terminate telecommunications traffic, they have a
14 reduced incentive to upgrade their networks to the most efficient
15 technology or to negotiate interconnection agreements that are designed to
16 accommodate the efficient exchange of IP traffic, as both actions would
17 likely lead to reduced intercarrier payments.³⁶

18 Indeed, in its most recent proposal to reform interstate switched access charges the FCC
19 proposed to implement even more restrictive measures on how CLECs and ILECs price
20 interstate access.³⁷ At this time there is no indication as to whether or when an actual
21 order might be issued, however. Thus, the passage of time has made clear that the
22 Commission cannot assume the role of spectator and wait to see if and when the FCC
23 takes action. Inaction by the Commission would have harmful consequences for

1 consumers, businesses, and competition in Arizona. The Commission should instead
2 work to reduce the most egregious problems that fall within its own jurisdiction. States
3 currently retain the same jurisdiction over intrastate rates they have had since access
4 charges were first implemented in 1984 and, for reasons I address below, have more
5 compelling social policy reasons to reduce intrastate access rates than ever before.
6 Indeed, as I will discuss, many states have already implemented reforms.

7 **V. The Current Access/Interconnection Charge Regime Is Highly Asymmetric (Issues**
8 **1 and 2)**

9 **A. Access Rates Paid by Wireline IXC's Are Much Higher for Intrastate Long**
10 **Distance Calls Than for Interstate Long Distance Calls, and Are Much Higher Than**
11 **Local Call Termination Rates, Even Though Those Rates Are All for the Same**
12 **Functionality**

13 **Q: DID THE FCC'S ACCESS CHARGE REDUCTIONS THAT YOU HAVE**
14 **DISCUSSED APPLY TO ALL LONG DISTANCE TELEPHONE CALLS?**

15 **A:** No. The FCC implemented reductions to interstate switched access rates, which apply to
16 interstate long distance calls, not intrastate long distance calls, which have historically
17 been under state jurisdiction. As a result, wireline long distance providers are assessed
18 much *higher* rates in Arizona for intrastate long distance calls than for origination and

³⁶ 2008 NPRM, Appendix A, ¶ 189.

³⁷ 2008 NPRM, Appendix A, ¶¶ 186-236.

1 termination of interstate calls even though (as I discussed above) the LEC's origination
2 and termination functions are the same for interstate and intrastate calls.

3 **Q: HOW ARE INTRASTATE ACCESS CHARGES APPLIED IN ARIZONA?**

4 A: A LEC charges intrastate access fees for the origination or termination of long distance
5 wireline circuit switched calls that originate *and* terminate in Arizona. Hence, a wireline
6 call that originates in one local calling area in Arizona and terminates in another local
7 calling area in Arizona is an intrastate long distance call to which intrastate access
8 charges would apply.

9 **Q: YOU EXPLAINED THAT THE FCC HAS DECREASED INTERSTATE ACCESS**
10 **CHARGES SUBSTANTIALLY SINCE THEY WERE FIRST INSTITUTED IN**
11 **THE 1980s. HAVE THERE BEEN CORRESPONDING REDUCTIONS IN THE**
12 **ACCESS CHARGES APPLICABLE TO ARIZONA INTRASTATE TOLL**
13 **CALLS?**

14 A: No. Intrastate switched access charges in Arizona do not reflect federal reforms, leading
15 to intrastate rates that are much higher than interstate rates (and cost-based rates) for the
16 same function. As a result, Qwest's intrastate rates remain more than double its interstate
17 rates. Other carriers are charging intrastate access rates that are an even larger multiple
18 of their interstate rates; in fact, one carrier charges for intrastate switched access at a rate
19 over 40 times higher than the fee charged for the same service if the call is interstate.

1 Q: **WHAT ARE THE ACCESS RATES CHARGED TODAY BY INCUMBENT LECs**
2 **IN ARIZONA TO WIRELINE IXCS?**

3 A: The access rates charged by incumbent LECs in Arizona today are shown in Table 1,
4 below.

5 It is useful to understand that access rates are not a single number but instead consist of
6 many rate elements that combine to provide the access service. Some of these rate
7 elements are priced on a flat rate (e.g., per month) basis, some on a per-minute-per mile
8 basis, and some on a per minute basis. Depending on which elements are requested by
9 the IXC seeking access, the configuration of the interconnection arrangement, and the
10 number of minutes processed, the average per minute rate paid by one IXC can differ
11 from the average paid by another, even to the same LEC. A common way to compare the
12 access rates of one LEC to another's is to compute the average per minute rate paid to a
13 given LEC by all IXCs, taking into account all the access rate elements purchased. The
14 table below provides the average per minute intrastate rate paid to ILECs based on actual
15 access revenues and access minutes of use provided by the LECs in discovery. The table
16 also shows the carriers' average interstate access charges.

Table 1

Arizona ILEC Access Charges to Wireline IXCs for
Call Origination and Call Termination Services

[BEGIN HIGHLY CONFIDENTIAL INFORMATION]



[END HIGHLY CONFIDENTIAL INFORMATION]

* Carriers were asked to provide only revenues from elements rated on a minute-of-use basis. It appears, however, that Qwest's revenues include elements for both intrastate and interstate access that are not rated on a minute-of-use basis.

Sources: Qwest, Verizon, and ALECA responses to Staff's Data Request STF 1.1.

This table demonstrates the significant disparities in the regulated rates charged by the ILECs for originating and terminating telephone traffic. Qwest's average intrastate access charge of [BEGIN CONFIDENTIAL INFORMATION] [REDACTED] [END CONFIDENTIAL INFORMATION] is more than double its average interstate access charge of [BEGIN CONFIDENTIAL INFORMATION] [REDACTED] [END CONFIDENTIAL INFORMATION]. Verizon's average intrastate access charge of [BEGIN HIGHLY CONFIDENTIAL INFORMATION] [REDACTED] [END HIGHLY CONFIDENTIAL INFORMATION] is over 40 times as large as its average

1 interstate access charge of [BEGIN HIGHLY CONFIDENTIAL INFORMATION]
2 [REDACTED] [END HIGHLY CONFIDENTIAL INFORMATION]. The intrastate
3 access rates charged on average by ALECA members of 11.42¢ per minute are about
4 seven times as large as the interstate access charge of 1.66¢ per minute.

5 In addition, an IXC pays switched access charges not only for call termination but also
6 for call origination if it does not also provide local service to the calling party (that is, if it
7 is providing "stand-alone" long distance service to the customer).³⁸ Hence, an IXC
8 providing stand-alone long distance service would pay [BEGIN HIGHLY
9 CONFIDENTIAL INFORMATION] [REDACTED] [END HIGHLY CONFIDENTIAL
10 INFORMATION] *per minute* to Verizon for an in-state toll call in Arizona, if Verizon
11 were the local service provider to the called and calling parties. If the call crossed state
12 boundaries, the per minute charges would instead be [BEGIN HIGHLY
13 CONFIDENTIAL INFORMATION] [REDACTED] [END HIGHLY
14 CONFIDENTIAL INFORMATION], assuming that Verizon's interstate access rate in
15 the other state was comparable to Verizon's interstate rate in Arizona.

16 Q: YOU EXPLAINED EARLIER THAT THE FUNCTIONALITY PROVIDED BY A
17 LEC TO TERMINATE A LONG DISTANCE CALL RECEIVED FROM AN IXC
18 IS THE SAME AS THE FUNCTIONALITY PROVIDED BY THE LEC TO
19 TERMINATE A LOCAL CALL RECEIVED FROM ANOTHER LEC. HOW DO

³⁸ A LEC that originates a call and also provides the long distance service on the call might, as an accounting matter, pay originating access to itself, but as a company, it does not bear the originating access fee as a cost.

**THE CHARGES FOR TERMINATING A LONG DISTANCE CALL COMPARE
TO THE CHARGES FOR TERMINATING A LOCAL CALL?**

A: Although the services provided by the ILEC to terminate another carrier's traffic to the ILEC's customer are functionally the same whether the ILEC is terminating a local call or a toll call, there is a tremendous disparity between the regulated rates for terminating toll calls and local calls. For instance, according to data provided in discovery, a CLEC terminating a local call to a Verizon customer pays Verizon on average [BEGIN
HIGHLY CONFIDENTIAL INFORMATION] [REDACTED]
[REDACTED] [END HIGHLY CONFIDENTIAL INFORMATION]³⁹ for each minute of the call, whereas, as shown in Table 1, an IXC terminating an intrastate toll call to the same Verizon customer would pay Verizon approximately [BEGIN HIGHLY
CONFIDENTIAL INFORMATION] [REDACTED] [END HIGHLY CONFIDENTIAL
INFORMATION] per minute—over 200 times as much as the CLEC pays for the same terminating functionality.

Q: WHAT ARE THE ACCESS PRICES CHARGED BY CLECS IN ARIZONA?

A: Table 2 below provides the average per minute intrastate and interstate access rates charged by the CLECs that provided relevant data in response to Staff's discovery

³⁹ Verizon Companies Response to AT&T Data Request No. 2.12. Computed as 2008 local interconnection revenues divided by 2008 local interconnection minutes of use. Qwest and all other LECs in this proceeding were also asked to provide local interconnection revenues and minutes of use from 2003 to 2008 that would have permitted me to calculate the average reciprocal compensation rates they charge, but only Verizon and

1 requests. As with Table 1, Table 2 illustrates the disparities between interstate and
2 intrastate rates charged by CLECs. In all cases, intrastate rates are multiples of the
3 interstate rates.

4 **Table 2**

5 **Arizona CLEC Access Charges to Wireline IXCs**
6 **for Call Origination and Call Termination Services**

7 **[BEGIN HIGHLY CONFIDENTIAL INFORMATION]**



8 **[END HIGHLY CONFIDENTIAL INFORMATION]**

9 ^ Carriers were asked to provide only revenues from elements rated on a minute-of-use basis.
10 It appears, however, that Integra's and XO's revenues include elements that are not rated on
11 a minute-of-use basis.

12 * Average of TCG, AT&T, and SBC LD

13 ** Average of Electric Lightwave, Eschelon, and Mountain Communications

14 *Sources: CLEC responses to Staff's Data Request STF 1.1.*

Integra provided that information. See Qwest Responses to AT&T Data Request No. 3.12 and other LECs' Responses to AT&T Data Request No. 2.10. Some LECs have not yet responded to this request.

1 **B. The Current System of Intercarrier Compensation Is Highly Asymmetric Across**
2 **Technologies**

3
4 Q: **ARE ACCESS CHARGES APPLIED SYMMETRICALLY ACROSS**
5 **TECHNOLOGIES?**

6 A: No, not at all. The application of interconnection rates differs significantly across
7 technologies, including wireless, VoIP, and other communications platforms.

8 Q: **HOW ARE ACCESS CHARGES APPLIED DIFFERENTLY TO WIRELESS**
9 **CALLS?**

10 A: Wireless providers are not charged intrastate access rates for intrastate wireless calls
11 except in very limited circumstances. Under FCC rules established in 1996, if a call
12 originates on a wireless phone and goes to a LEC's customer without crossing the
13 boundary of a Major Trading Area ("MTA"), it is considered a "local" call for purposes
14 of interconnection fees (even if the call crosses a state boundary, a LATA boundary,
15 and/or a LEC local calling area boundary) and the LEC charges reciprocal compensation
16 rates, which are much lower than switched access rates.⁴⁰ Wireless carriers are subject to
17 switched access rates only on calls that (1) terminate to a LEC customer, and (2) cross an
18 MTA boundary.

⁴⁰ 1996 Interconnection Order, ¶¶ 1034-1036.

1 **Q: CAN YOU PLEASE DESCRIBE THE DIFFERENCES BETWEEN MTAS AND**
2 **WIRELINE LOCAL CALLING AREAS IN ARIZONA?**

3 **A:** Yes. The difference is huge. In fact, there are only three MTAs in all of Arizona, two of
4 which extend well beyond Arizona's borders, while there are hundreds of local individual
5 wireline calling areas in Arizona. Moreover, the two biggest cities in Arizona, Phoenix
6 and Tucson, are in the same MTA. Figure 2 shows the rate centers that comprise the
7 local calling areas of the Phoenix and Tucson areas and shows the Phoenix MTA, which
8 is the MTA in which these two local calling areas reside. A wireline call originating in
9 Phoenix must terminate within the Phoenix local calling area (i.e., must go to a customer
10 in one of those Phoenix rate centers circled on the map) to qualify for reciprocal
11 compensation rates for termination. In contrast, a wireless call originating in Phoenix
12 could go to anywhere in the entire area indicated as the Phoenix MTA, which includes
13 Tucson and most of the geographic area of Arizona, and still qualify to pay reciprocal
14 compensation rates rather than the much higher intrastate switched access rates for the
15 same functionality. Hence, for example, the IXC carrying a wireline call from Phoenix to
16 Tucson would pay intrastate access charges to the LEC terminating the call (and the LEC
17 originating the call); but if the call were placed on the customer's wireless phone, the
18 wireless carrier would pay only reciprocal compensation rates to the same LEC to
19 terminate the call to the same called party (and would pay no originating access charge at
20 all).

1 Figure 3 expands Figure 2 to show the size of the three MTAs in Arizona and
2 surrounding states. The Los Angeles MTA encompasses Southern California, a portion
3 of Nevada, and a portion of Arizona. The El Paso-Albuquerque MTA extends beyond
4 the state border and includes most of New Mexico and parts of Utah, Texas, and
5 Colorado. For additional perspective, there are 93 separate local calling areas that lie
6 within the Phoenix MTA. Any wireless call within the entire MTA qualifies for the
7 reciprocal compensation rate for termination, rather than the (much higher) access rate.

Figure 2

MTAs Are Far Larger Than Local Calling Areas in Arizona

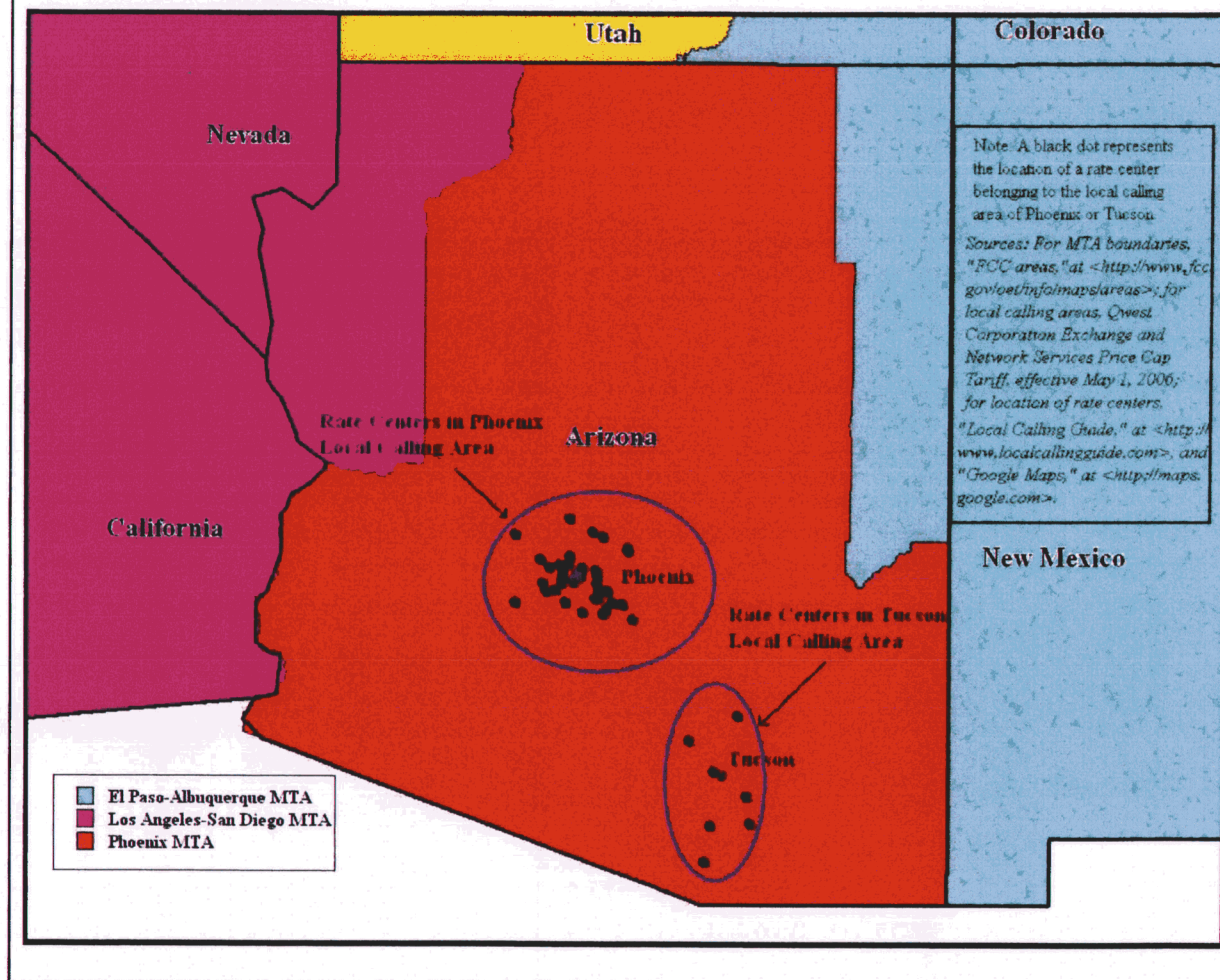
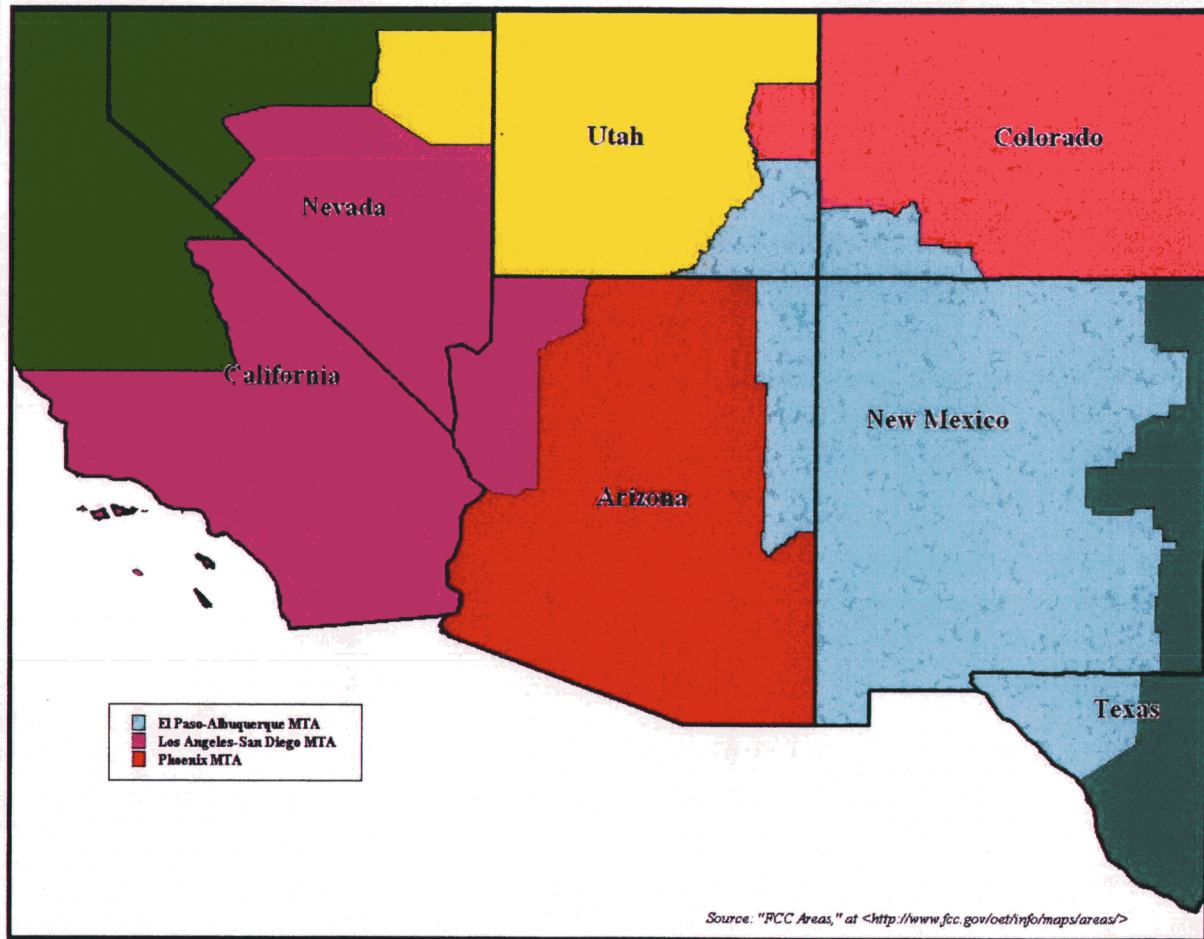


Figure 3

One MTA in Arizona Covers Most of the State and the Other Two Span Several States



1 **Q: WHAT RATES DO WIRELINE LECs IN ARIZONA CHARGE TO WIRELESS**
2 **COMPANIES TO TERMINATE INTRAMTA CALLS?**

3 According to the LECs' responses to discovery, the rates charged to terminate intraMTA
4 wireless calls vary, but in all cases the termination rates for intraMTA wireless calls are
5 far below the rates charged to wireline LECs for intrastate access, as Table 3
6 demonstrates:

Arizona Corporation Commission
Docket No. RT-00000H-97-0137
Docket No. T-00000D-00-0672
Direct Testimony of Dr. Debra J. Aron

Table 3

Arizona LEC Charges for Call Termination

[BEGIN HIGHLY CONFIDENTIAL INFORMATION]



*

[END HIGHLY CONFIDENTIAL INFORMATION]

** For Integra, intraMTA rates are the average of Electric Lightwave and Eschelon, computed as total reciprocal compensation revenues divided by reciprocal compensation minutes billed to wireless carriers. Integra's intrastate and interstate access rates are the average of Electric Lightwave, Eschelon, and Mountain Communications.

Sources: Qwest Supplemental Responses to AT&T's Data Requests 3.9, Cox Communications and Verizon Responses to AT&T's Data Request 2.9; Integra Responses to AT&T's Data Request 2.8; and Parties' Responses to Staff's Data Request STF 1.1.

Q: DO VOIP PROVIDERS PAY ACCESS CHARGES?

A: This is a disputed area of intercarrier compensation, which the FCC has not resolved. A number of carriers have petitioned the FCC seeking clarification or ruling on this issue, indicating that VoIP providers seek to avoid access charges by appealing to current

1 regulatory ambiguity.⁴¹ To the extent that VoIP providers are currently able to avoid
2 access charges, they also enjoy a competitive advantage over wireline IXC's, who must
3 pay inflated intrastate access rates.

4 **Q: DO ACCESS CHARGES APPLY TO OTHER BROADBAND FORMS OF**
5 **COMMUNICATION, SUCH AS COMPUTER-TO-COMPUTER CALLING?**

6 **A:** No. Communication methods that avoid the public switched telephone network entirely,
7 such as computer-to-computer voice calling (an example is Skype-to-Skype), instant
8 messaging, social networking such as Facebook, and email, are not subject to the access
9 charge regime at all.⁴²

10 **C. Many Other States Have Already Reduced the Intrastate Access Rates that**
11 **ILECs and CLECs Can Charge**
12

⁴¹ See, for example, *In the Matter of Feature Group IP Petition for Forbearance Pursuant to 47 U.S.C. Section 160(c) from Enforcement of 47 U.S.C. Section 251(g), Rule 51.701(a)(1), and Rule 69.5(b)*, before the Federal Communications Commission, Docket No. WC 07-256 (October 23, 2007); and *In the Matter of Petition of the Embargo Local Operating Companies for Limited Forbearance Under 47 U.S.C. Section 160(c) from Enforcement of Rule 69.5(a), 47 U.S.C. Section 251(b) and Commission Orders on the ESP Exemption*, before the Federal Communications Commission, Docket No. WC 08-8 (January 11, 2008).

⁴² See Memorandum Opinion and Order, *In the Matter of Petition for Declaratory Ruling that pulver.com's Free World Dialup is Neither Telecommunications Nor a Telecommunications Service*, before the Federal Communications Commission, FCC 04-27 (released February 19, 2004), ¶¶ 15-22 (finding that peer-to-peer applications that connect users over the Internet and make no use of the public switched telephone network are not subject to common-carrier-type regulations). See, also, Jonathan E. Nuechterlein and Philip J. Weiser, *Digital Crossroads: American Telecommunications Policy in the Internet Age* (2007), and pp. 198-199, and p. 303 ("Because IP-to-IP calls never leave the Internet and never touch the public switched network, any compensation arrangements between the firms involved—i.e., ISPs, Internet backbone providers, and the VoIP provider itself—are unregulated.").

1 Q: HAVE OTHER STATES REFORMED ILECS' INTRASTATE ACCESS RATES?

2 A: Yes. In a number of states, major ILECs have been mandated to reduce intrastate access
3 rates by state statute or administrative rules. These states include Maine,⁴³ Texas,⁴⁴
4 Michigan,⁴⁵ and New Mexico,⁴⁶ where the statute or administrative code has provisions
5 ordering intrastate mirroring of interstate access rates. In other states, including
6 Georgia,⁴⁷ Kansas,⁴⁸ Nevada,⁴⁹ and Wisconsin,⁵⁰ the statute mandates mirroring of
7 interstate and intrastate access rates as a condition for granting ILECs retail pricing
8 flexibility. An inspection of the major ILEC's interstate and intrastate tariffs shows that
9 the local switching and Carrier Common Line charges are in fact approximately mirrored
10 in each of these states.

11 Indiana also has a statutory mandate for the mirroring of interstate and intrastate access
12 charges. The Indiana statute directs the state utilities commission to "consider the
13 provider's rates and charges for intrastate access service to be just and reasonable if the
14 intrastate rates and charges mirror the provider's interstate rates and charges" in all

⁴³ ME. REV. STAT. ANN. TIT. 35-A, Part 7, Chapter 71, § 7101-B. CODE ME. R. 65-407, Ch. 280, § 8B.

⁴⁴ Public Utility Regulatory Act, Title II, Texas Utility Code, §§ 65.201-205, and 52.155 (2007).

⁴⁵ Michigan Telecommunications Act, Chapter 484.2310, § 310 (1991).

⁴⁶ N.M. ADMIN. CODE TIT. 17, Chapter 11, §§ 10.6, 10.8.C (current though July 1, 2008). In addition, the Oklahoma statute requires LECs serving 15 percent or more of the access lines in the state to keep intrastate access rates in parity with interstate access rates until its intrastate access revenues have been reduced by \$16.5 million. O.S. § 17-139.103 D.3-4, E (1997); OAC 165:55-5-66(2).

⁴⁷ GA. CODE ANN. § 46-5-166(f)(1) and f(2) (1995).

⁴⁸ KAN. STAT. ANN. §§ 66-2005(c), (f).

⁴⁹ NEV. ADMIN. CODE ch. 704 § 704.6898; also § 704.68952.

1 proceedings where intrastate access rates are at issue, including interconnection
2 agreements.⁵¹ AT&T Indiana is the major ILEC in Indiana, and its intrastate local
3 switching and common carrier line charges in Indiana are identical to its interstate rates.

4 In a number of states, access charge reductions have been ordered by state commissions
5 without legislative requirement:

- 6 • The Illinois Commerce Commission ("ICC") adopted a mirroring policy in 1983,
7 based on the recognition that "the costs associated with interstate and intrastate
8 access minutes were essentially the same (since the network functions are the same)
9 and that rate differentials could create significant rate arbitrage opportunities."⁵² In
10 2000, the ICC directed ILECs to remove non-cost-based rate elements and reduce the
11 rates in the cost-based elements of their intrastate switched access charges.⁵³ The
12 current local switching intrastate rate in Illinois for AT&T, the major ILEC, is
13 slightly lower than the interstate rate.
- 14 • In Ohio, the Public Utilities Commission has required ILECs to mirror intrastate and
15 interstate access rates since 1987,⁵⁴ and it imposed the same requirement on CLECs
16 in 2007.⁵⁵

⁵⁰ See WIS. STAT. ANN. § 196.196, and in particular § 196.196(2)(b).

⁵¹ IND. CODE § 8-1-2.6-1.5 (c) (2).

⁵² Interim Order, *In the matter of Illinois Commerce Commission On Its Own Motion vs. Illinois Bell Telephone Company et al., Investigation Into Non-Cost Based Access Charge Rate Elements in the Intrastate Access Charges of Incumbent Local Exchange Carriers in Illinois et al.*, before the Illinois Commerce Commission, Docket Nos. 97-0601, 97-0602 and 97-0516, (December 16, 1998), 1998 Ill. PUC LEXIS 1148 at *12. See also, Order, *In the matter of Illinois Commerce Commission on its Own Motion vs. Illinois Bell Telephone Company; et al., Investigation Into Non-Cost Based Access Charge Rate Elements in the Intrastate Access Charges of Incumbent Local Exchange Carriers in Illinois et al.*, before the Illinois Commerce Commission, Docket Nos. 97-0601, 97-0602 and 97-0516, (March 29, 2000), (hereafter *2000 Illinois Order*), 2000 Ill. PUC LEXIS 1004 at *11-12.

⁵³ *2000 Illinois Order*, at **118-131.

⁵⁴ Opinion and Order, *In the Matter of the Commission Investigation Relative to Establishment of Intrastate Access Charges*, before the Public Utilities Commission of Ohio, Case No. 83-464-TP-COI (Subfile C), (March 12, 1987), 1987 Ohio PUC LEXIS 100 at *20.

⁵⁵ Entry on Rehearing, *In the Matter of the Establishment of Carrier-to-Carrier Rules*, before the Public Utilities Commission of Ohio, Case No. 06-1344-TP-ORD, (October 17, 2007), ¶ 29, p. 18.

- 1 • In 1995, the Mississippi Public Service Commission issued an order requiring South
2 Central Bell to reduce intrastate switched access to parity with interstate rates as of
3 January 1, 1996, and to adjust its rates annually, "subject to a cap at parity throughout
4 the life of the plan."⁵⁶
- 5 • Also in 1995, the Commission approved Kentucky BellSouth's regulation plan
6 subject to the requirement that BellSouth's switched access rate elements mirror
7 interstate rates.⁵⁷
- 8 • In 1997, the Tennessee Regulatory Authority ordered BellSouth to reduce its
9 intrastate access rates to the level of its interstate access rates as of August 1, 1995, as
10 part of a settlement in a dispute between BellSouth and MCI and Sprint.⁵⁸
- 11 • In Massachusetts, the Department of Telecommunications and Energy ordered
12 Verizon to lower its intrastate switched access charges "to the more cost-based
13 interstate levels" while allowing for retail rate increases that were expected to
14 "enhance[] efficiency without negatively impacting universal service."⁵⁹
- 15 • In West Virginia, the Commission's 2007 Order approving Verizon's Market
16 Transition (i.e., retail rate flexibility) Plan contains a provision that eliminates
17 Verizon's Carrier Common Line Charge ("CCLC") and requires its intrastate traffic-
18 sensitive rates to mirror interstate rates after a transition period.⁶⁰

⁵⁶ Final Order, *In re: Order of the Mississippi Public Service Commission Establishing a Docket to Consider Formulating a Properly Structured Price Regulation Plan for South Central Bell*, before the Mississippi Public Service Commission, Docket No. 95-UA-313, (November 1, 1995), p. 12.

⁵⁷ Order, *In the Matter of the Tariff Filing of BellSouth Telecommunications, Inc. to Mirror Interstate Access Rates*, before the Kentucky Public Service Commission, Case No. 98-065, (March 31, 1999), 1999 Ky. PUC LEXIS 102 at *1; Order, *In the Matter of: Application of BellSouth Telecommunications, Inc., d/b/a South Central Bell Telephone to Modify Its Method of Regulation*, before the Kentucky Public Service Commission, Case No. 94-121 (August 2, 1999), 1999 Ky. PUC LEXIS 75 at *1.

⁵⁸ Order, *In Re: Tariff Filing by BellSouth Telecommunications, Inc. to Reduce Intrastate Access Charges (Tariff 97-029)*, before the Tennessee Regulatory Authority, Docket No. 97-00185, (February 14, 1997), p. 1; "BellSouth Reduces Access Charges," *Communications Today*, February 3, 1997.

⁵⁹ Order, *In the matter of Investigation by the Department of Telecommunications and Energy on its own Motion into the Appropriate Regulatory Plan to succeed Price Cap Regulation for Verizon New England, Inc. d/b/a Verizon Massachusetts' intrastate retail telecommunications services in the Commonwealth of Massachusetts*, before the Massachusetts Department of Telecommunications and Energy, D.T.E. 03-31-Phase I, (May 8, 2002), p. 63.

⁶⁰ Commission Order, *In the matter of Petition for Approval of Joint Stipulation and Agreement for Settlement and Joint Petition for Expedited Approval of a Joint Stipulation for a Market Transition Plan for Verizon West Virginia Inc.*, before the Public Service Commission of West Virginia, Case No. 06-1935-T-PC, (March, 26, 2007), pp. 3, 12-14 of Joint Stipulation and Agreement for Settlement. Five other states that have imposed mirroring requirements are Alabama, Iowa, Nebraska, North Carolina, and Oregon. The Commission in

1 In all, I am aware of over 20 states that have reformed ILECs' intrastate access rates and
2 have targeted the intrastate rates to interstate levels. As I will show later in this
3 testimony, these reforms have brought significant and measurable benefits to consumers
4 in those states.

Alabama required South Central Bell to maintain intrastate access charges at a level at or below interstate access rates as a condition for approving its price regulation plan. See Report and Order, *In Re Petition of South Central Bell Telephone Company to Restructure its Form of Regulation, et al., before the Alabama Public Service Commission*, Docket Nos. 24499, 24472, 24030, 24865, (September 1995), ¶ 09.04. This requirement was modified in the 2004 Price Cap Plan, which required BellSouth and other ILECs to cap intrastate access services at the "effective intrastate level," so that rates today are capped at the 2004 interstate level. In Iowa, the statute mandates carriers submitting a price regulation plan to include a proposal "for reducing the local exchange carrier's average intrastate access service rates to the local exchange carrier's average interstate access service rates in effect as of the last day of the calendar year immediately preceding the date of filing of the plan." See IA. CODE ANN. §§ 476.97.1, 476.97.3 (2008). Qwest's initial price plan was filed in 1998 and has been renewed at least twice, but it appears that the major components of its intrastate access charges (the local switching rates and the common carrier line charge) have not been revised since 2001, while interstate access rates have, so its intrastate rates do not mirror current interstate rates. See, Order Approving Renewed Price Regulation Plan, *In re: Qwest Corporation, Iowa Utilities Board*, Docket No. RPU-01-10, 2004 Iowa PUC LEXIS 566 (December 13, 2004); Qwest Corporation, Iowa Tariff No. 4, Access Service, sections 3.9 and 6.8.2 (A); and Qwest Corporation, Tariff FCC No. 1, sections 3.9 and 6.8.2 (A). The Nebraska Public Service Commission concluded in 1999 that the intrastate access charge structure for non-rural carriers "should approximate the interstate access charge structure," and in 2002, the Nebraska Commission reached the same conclusion for rural carriers. See Order, *Re: Investigation into Intrastate Access Charge Reform, before the Nebraska Public Service Commission*, Application No. C-1628, (January 13, 1999), pp. 7-8; and Findings and Conclusions, *In the Matter of the Nebraska Public Service Commission, on its own Motion, Seeking to Conduct an Investigation of Intrastate Access Charges for Rural ILECs*, before the Nebraska Public Service Commission, Application No. NUSF-28, (November 26, 2002), ¶¶ 27, 31. This order did not mandate strict mirroring between interstate and intrastate rates and current intrastate rates do not mirror interstate rates. In 2000, the North Carolina Utilities Commission ordered BellSouth to reduce its intrastate switched access charges, noting that this would lessen "the disparity between intrastate and interstate long distance rates." Order Regarding Joint Stipulation, *In the Matter of Application by BellSouth Telecommunications, Inc., For, and Election of, Price Regulation et al.*, North Carolina Utilities Commission, (July 24, 2000), 2000 N.C. PUC LEXIS 104 at *93-94. The Commission ordered a reduction in intrastate rates but not strict parity. Today's intrastate rates do not match interstate rates. The Public Utility Commission of Oregon approved Qwest's rate rebalancing plan in 2001, and required Qwest to reduce switched access rates to "bring Qwest's intrastate switched access rates closer to its currently lower interstate switched access rates." Order, *In the matter of the Application of Qwest Corporation for an Increase in Revenues, before the Oregon Public Utility Commission*, Order No. 01-810, (September 14, 2001), 2001 Ore. PUC LEXIS 449 at *17-18, 32. This plan apparently did not require parity between interstate and intrastate rates and the rates are not in parity today.

1 Q: YOU EXPLAINED THAT THE FCC CAPS CLECS' INTERSTATE ACCESS
2 RATES AT THE LEVEL OF THE COMPETING ILEC. HAVE OTHER STATES
3 LIMITED CLECS' INTRASTATE ACCESS RATES AS WELL?

4 A: Yes. In a number of states, CLECs' intrastate access rates have been capped at the level
5 of the competing ILEC's rates. These states include Alaska,⁶¹ Louisiana,⁶² Maine,⁶³
6 Maryland,⁶⁴ Massachusetts,⁶⁵ Missouri,⁶⁶ New Hampshire,⁶⁷ New Mexico,⁶⁸ New York,⁶⁹
7 Ohio,⁷⁰ Pennsylvania,⁷¹ Texas,⁷² Virginia,⁷³ and Washington.⁷⁴

⁶¹ Alaska Intrastate Interexchange Access Charge Manual, §§ 001(d) and (e), 003, and 102 (April 28, 2004).

⁶² Order No. U-17949-TT, *In re: Development of regulatory plan for South Central Bell, including assessment of alternative forms and methods of regulation; depreciation methods and expensing; cost of capital; capital structure; and other related matters*, Louisiana Public Services Commission, March 15, 1996 (corrected May 3, 1996), Section 301 (k)(4) of Exhibit 1.

⁶³ CODE ME. R. 65-407 Ch. 280 §§ 2J, 8B.

⁶⁴ MD. REGS. CODE §§ 20.45.09.01, 20.45.09.02(b)(4), 20.45.09.02(b)(5)(a), 20.45.09.03(b).

⁶⁵ Final Order, *In the matter of Petition of Verizon New England, Inc., MCI Metro Access Transmission Services of Massachusetts, Inc., d/b/a Verizon Access Transmission Services, MCI Communications Services, Inc., d/b/a Verizon Business Services, Bell Atlantic Communications, Inc., d/b/a Verizon Long Distance, and Verizon Select Services, Inc. for Investigation under Chapter 159, Section 14, of the Intrastate Access Rates of Competitive Local Exchange Carriers*, before the Commonwealth of Massachusetts department of Telecommunications and Cable, D.T.C. 07-9, June 22, 2009.

⁶⁶ Report and Order, *In the Matter of an Investigation of the Actual Costs Incurred in Providing Exchange Access Service and the Access Rates to be Charged by Competitive Local Exchange Telecommunications Companies in the State of Missouri*, before the Public Service Commission of the State of Missouri, Case No. TR-2001-65, August 26, 2003, Ordering Clause No. 4.

⁶⁷ N.H. CODE ADMIN. R. ANN. (PUC) 431.07 and 449.07(f)(3).

⁶⁸ N.M. ADMIN. CODE at 17.11.10.8.C; at 17.11.10.7.R; and at 17.11.10.2.

⁶⁹ Opinion and Order Establishing Access Charges for New York Telephone Company and Instituting a Targeted Accessibility Fund, *In the matter of Proceeding on Motion of the Commission to Examine Issues Related to the Continuing Provision of Universal Service and to Develop a Regulatory Framework for the Transition to Competition in the Local Exchange Market; Proceeding on Motion of the Commission as to the Impact of the Modification of Final Judgment and the Federal Communications Commission's Docket 78-72 on Provision of Toll Service in New York State*, before the New York Public Service Commission, Case 94-C-0095, Case 28425, June 2, 1998, 1998 N.Y. PUC LEXIS 325 at *41.

⁷⁰ Entry on Rehearing, *In the Matter of the Establishment of Carrier-to-Carrier Rules*, before the Public Utilities Commission of Ohio, Case No. 06-1344-TP-ORD, October 17, 2007, p. 18.

⁷¹ PA. CONN. STAT. ANN. Title 66, § 3017(c) (2008).

⁷² Public Utility Regulatory Act, Title II, Texas Utility Code, §52.155 (2007).

1 In addition, some states have a policy constraining access rates that applies equally to
2 CLECs and ILECs. Examples of such states are Maine, where all carriers are required to
3 mirror their own interstate access rates;⁷⁵ Connecticut, where the DPUC ordered all
4 carriers to cap their intrastate access rates at 1.5¢ per minute;⁷⁶ and Indiana, where
5 intrastate access rates for all carriers are considered just and reasonable if they mirror
6 interstate rates.⁷⁷ In Illinois the Commission has issued orders over the years requiring
7 individual CLECs to cap their access rates at the ILEC rate.⁷⁸ More recently, in June of
8 2009, the Staff of the Illinois Commerce Commission (ICC) submitted reports
9 recommending that the ICC open investigations into whether the intrastate access charges

⁷³ VA. ADMIN. CODE Chapter 417, 5-417-50 (E)(1).

⁷⁴ WAC 480-120-540(2). In Missouri, New York, Ohio, Pennsylvania, and Texas, the ILEC cap may be lifted if CLECs demonstrate with a cost study that higher rates are warranted. I am aware of no state in which such a demonstration has been made. In addition, in California and Iowa, CLECs have been required to reduce their rates, but not quite to the ILEC level. In California, CLECs have been ordered to reduce their intrastate access charges "to the higher of AT&T's or Verizon's intrastate access charges, plus 10%." See Final Opinion Modifying Intrastate Access Charges, *Order Instituting Rulemaking to Review Policies Concerning Intrastate Access Charges*, before the Public Utilities Commission of the State of California, Rulemaking 03-08-018 (December 6, 2007). In Iowa, the Administrative Code orders CLECs that concur with the Iowa Telephone Association (ITA) Access Service Tariff No.1 to reduce their CCL charge if they offer service "in exchanges where the incumbent local exchange carrier's intrastate access rate is lower than the ITA access rate." See IAC 199—22.14(2)(d)(1)2.

⁷⁵ CODE ME. R. 65-407 Ch. 280 §§ 2J, 8B.

⁷⁶ Decision, *DPUC Investigation Of Intrastate Carrier Access Charges*, before the Connecticut Department of Public Utility Control, Docket No. 02-05-17 (February 18, 2004) 2004 Conn. PUC LEXIS 15 at *45-46.

⁷⁷ IND. CODE § 8-1-2.6-1.5 (c) (2).

⁷⁸ See, for example, Arbitration Decision, *AT&T Communications of Illinois, Inc., TCG Illinois and TCG Chicago Verified Petition for Arbitration of Interconnection Rates, Terms and Conditions and Related Arrangements with Illinois Bell Telephone Company (SBC Illinois) pursuant to Section 252 (b) of the Telecommunications Act of 1996*, before the Illinois Commerce Commission, 03-0239 (August 26, 2003), 2003 Ill. PUC LEXIS 715 at *352-353; and Arbitration Decision, *TDS Metrocom, Inc.: Petition for Arbitration of Interconnection Rates, Terms and Conditions and Related Arrangements with Illinois Bell Telephone Company d/b/a Ameritech Illinois Pursuant to Section 252(b) of the Telecommunications Act of 1996*, before the Illinois Commerce Commission, 01-0338 (August 8, 2001), 2001 Ill. PUC LEXIS 829 at *111-112.

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1 assessed in Illinois by 5 CLECs are just and reasonable.⁷⁹ The Staff reports cite the
2 actions by the FCC to cap interstate rates based on the FCC's finding that CLECs' rates
3 for access reflect monopoly power, and cited the "excessive" rates of these CLECs in
4 Illinois.⁸⁰ The ICC issued orders in July initiating investigations of these five CLECs'
5 intrastate access charges as recommended by Staff.⁸¹ Following these actions, as of the
6 writing of this testimony, two of the CLECs under investigation have filed tariff changes
7 reducing their intrastate rates to mirror their rates to those of AT&T and Verizon.⁸²

⁷⁹ Illinois Commerce Commission Telecommunications Division Staff Reports dated June 26, 2009 recommending investigations into the intrastate access rates of McLeodUSA Telecommunications Services; Bullseye Telecom, Inc.; Delta Communications, LLC d/b/a Clearwave Communications; Nexus Communications, Inc. d/b/a TSI Telephone Company; and Norlight, Inc. d/b/a Cinergy Communications.

⁸⁰ See, for example, Illinois Commerce Commission Telecommunications Division Staff recommending an investigation into the intrastate access rates of McLeodUSA Telecommunications Services, June 26, 2009, p. 4. ("Intrastate access rates charged by some Illinois CLECs are similar to those found to be excessive by the FCC.")

⁸¹ Order, *Investigation into whether Intrastate Access Charges of McLeodUSA Telecommunications Services, Inc. d/b/a PAETEC Business Services are just and reasonable*, before the Illinois Commerce Commission, 09-0315 (July 8, 2009); Order, *Investigation into whether Intrastate Access Charges of Delta Communications, LLC d/b/a Clearwave Communications are just and reasonable*, before the Illinois Commerce Commission, 09-0314 (July 8, 2009); Order, *Investigation into whether Intrastate Access Charges of Nexus Communications, Inc. d/b/a TSI Telephone Company are just and reasonable*, before the Illinois Commerce Commission, 09-0316 (July 8, 2009); Order, *Investigation into whether Intrastate Access Charges of Norlight, Inc. d/b/a Cinergy Communications are just and reasonable*, before the Illinois Commerce Commission, 09-0317 (July 8, 2009); Order, *Investigation into whether Intrastate Access Charges of Bullseye Telecom, Inc. are just and reasonable*, before the Illinois Commerce Commission, 09-0313 (July 8, 2009).

⁸² Letter from Ronald Munn, Consultant to Nexus Communications, Inc. re: Changes to the Competitive Access Provider Services Tariff of Nexus Communications, Inc. August 19, 2009, attaching revised tariff pages 2 and 50 of the Competitive Access Provider Services Tariff, I.C.C. Tariff No. 2; Notice of Tariff Filing, *Investigation into whether Intrastate Access Charges of Norlight, Inc. d/b/a Cinergy Communications are just and Reasonable*, 09-0317 (August 24, 2009).

1 VI. **Excessive Access Rates Harm Consumers, Harm Competition, and Distort**
2 **Investment (Issues 1 and 2)**

3 Q: **WHY SHOULD THE COMMISSION BE CONCERNED ABOUT EXCESSIVE**
4 **INTRASTATE ACCESS RATES IN ARIZONA?**

5 A: Excessive intrastate access rates directly and indirectly harm consumers and businesses
6 in Arizona. They directly harm consumers and businesses because higher intrastate
7 access rates cause higher retail prices for long distance services. Excessive intrastate
8 access rates also indirectly harm consumers and businesses by discouraging wireline long
9 distance usage, driving up the cost of operating businesses in Arizona, distorting
10 competition, and distorting investment. They also create arbitrage opportunities that
11 waste resources generally, and they siphon revenues from IXC's and their customers for
12 the benefit of chat lines and similar businesses that were not the intended beneficiaries of
13 subsidies provided on the backs of long distance customers.

14 **A. Excessive Access Rates Harm Consumers by Inflating Retail Prices of Long**
15 **Distance Services**

16 Q: **HOW DO EXCESSIVE ACCESS PRICES DIRECTLY HARM CONSUMERS?**

17 A: Excessive access prices harm consumers in several clearly identifiable ways. The most
18 direct harm to consumers is that excessive access prices charged to long distance
19 providers cause the prices consumers pay for retail long distance services to be higher

1 than they would otherwise be, so consumers pay more for the wireline long distance
2 services they use.

3 When an access provider charges excessive prices for access services, those excessive
4 prices generate revenue to the access provider but represent a cost to the company paying
5 the access: the IXC. The IXC, in turn, must price its retail service higher to recover that
6 cost. Excessive access prices therefore distort the pricing decisions of IXCs. This harms
7 consumers and reduces consumer welfare by forcing the prices for (some) long distance
8 services to be far in excess of the actual social cost of producing the services. For
9 example, if it costs the local exchange company B, say, 0.1¢ per minute to provide
10 access, but B charges the long distance company A, say, 1¢ per minute, the latter will
11 have to price long distance to its customers to recover the 1¢ rather than the genuine
12 social cost of 0.1¢. That increased cost to the IXC will result in higher long distance
13 prices. Conversely, lower access prices will lead to lower retail long distance prices.

14 **Q: ARE SWITCHED ACCESS CHARGES A SIGNIFICANT COMPONENT OF**
15 **LONG DISTANCE PRICES?**

16 **A:** Yes, they are. In Arizona, AT&T's average intrastate access expenses per minute were
17 about [BEGIN HIGHLY CONFIDENTIAL INFORMATION] ■ [END HIGHLY
18 CONFIDENTIAL INFORMATION] percent of AT&T's intrastate long distance
19 revenues per minute as of 2008, as can be seen in Figure 4.

Figure 4

AT&T Arizona Intrastate Switched Access Expenses and Long Distance Revenues

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[END HIGHLY CONFIDENTIAL INFORMATION]

1 Q: **WHAT IS THE IMPORTANCE OF THE FACT THAT INTRASTATE ACCESS**
2 **EXPENSES CONSTITUTE SUCH A HIGH PERCENTAGE OF AT&T'S**
3 **INTRASTATE LONG DISTANCE PRICES?**

4 A: Intrastate access prices are an incremental cost of providing long distance service (i.e.,
5 each additional call minute causes the long distance provider to incur an additional access
6 cost). Thus, material increases to the wholesale price of access would be expected to
7 cause a material increase in the retail price of long distance service; and material
8 decreases in the wholesale price of access would be expected to cause a material decrease
9 in the retail price of long distance service.⁸³

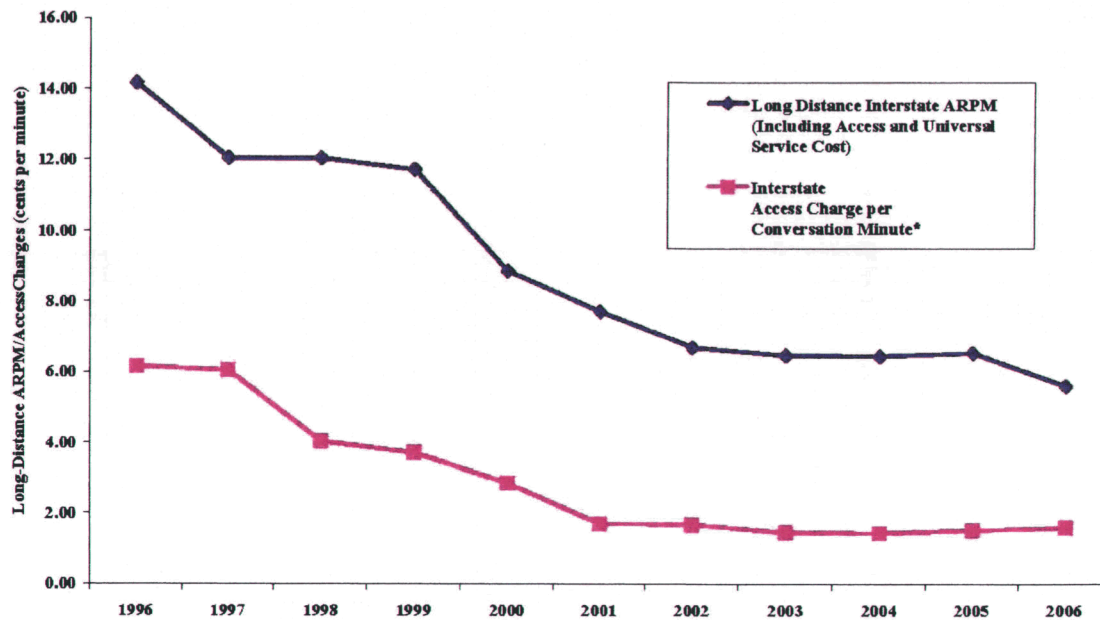
10 Q: **IS THERE EVIDENCE THAT THERE IS IN FACT A RELATIONSHIP**
11 **BETWEEN ACCESS RATES AND RETAIL LONG DISTANCE PRICES?**

12 A: Yes. First, the positive correlation between access rates and prices is apparent from a
13 simple visual inspection of the data on access charges and long distance rates over time
14 since 1996.

15 Figure 5 shows the national average of per-minute interstate access charges and the
16 average retail price (measured by average revenue per minute) of interstate long distance
17 calls. As you can see, the downward trend in interstate access charges has been
18 accompanied by a comparable trend in interstate long distance prices. Long distance
19 prices have fallen as access rates have fallen.

Figure 5

Interstate Access Charges and Interstate Long Distance Average Revenue per Minute



* Access charges are the average rates (weighted by minutes of use) for all local exchange carriers that file access tariffs subject to price-cap regulation and all LECs in the National Exchange Carrier Association (NECA) pool. The average access charges reported by the FCC do not include revenue per minute from subscriber line charges or primary interexchange carrier charges (PICCs). The total charge per conversation minute consists of charges on the originating end of the call, which are adjusted for dialing and call setup time, plus charges on the terminating end.

Source: FCC 2008 Trends, Tables 1.2 and 13.4

⁸³ Robert S. Pindyck and Daniel L. Rubinfeld, *MICROECONOMICS*, 3rd ed. (Englewood Cliffs, New Jersey: Prentice Hall, 1995), pp. 492-494.

1 Q: DR. ARON, HAVE YOU BEEN ABLE TO TEST AND QUANTIFY THE
2 RELATIONSHIP BETWEEN INTRASTATE ACCESS RATES AND
3 INTRASTATE LONG DISTANCE PRICES?

4 A: Yes. In order to investigate the relationship between intrastate access rates and intrastate
5 long distance prices, I requested and received data from AT&T on AT&T's intrastate
6 access rates and intrastate long distance prices for the years 2004 through 2008 (most
7 recently available), for all 50 US states.⁸⁴ The data are plotted in Figure 6. Each point
8 represents a state in a particular year.

⁸⁴ Specifically, I requested and received intrastate access expense minutes, intrastate expense revenues (that is, the amount of money paid by AT&T for intrastate access), intrastate toll revenues, and intrastate toll minutes. From these data I calculated AT&T's average intrastate long distance per minute price charged in each state for each year and AT&T's average intrastate access charge paid for each state for each year of my data. I assumed (and I found using the statistical techniques discussed below) that the average retail price charged by AT&T in year t is related to the average intrastate access rate charged to AT&T in year t-1, which reflects the fact that in general and in this circumstance, prices do not adjust instantaneously to changes in input prices. Hence, each point in Figure 6 is AT&T's average per minute price for intrastate long distance service in state j in year t on the vertical axis and the intrastate access rate in state j in year t-1 on the horizontal axis.

Figure 6

AT&T's Intrastate Toll Price versus Access Cost in 50 States, 2005-2008

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It is apparent simply from visual inspection of Figure 6 that there is a strong positive relationship on average between the intrastate access rate paid by AT&T and the average per minute intrastate long distance price charged by AT&T. In states/years where the

1 access rate paid is higher (the variable on the horizontal axis), the price charged (the
2 variable on the vertical axis) tends to be higher.

3 **Q: I NOTICE THAT YOU HAVE CIRCLED THE POINTS RELATED TO**
4 **ARIZONA. WHAT DOES THE PATTERN OF DATA IN ARIZONA SHOW?**

5 **A:** These points are isolated and replicated in Figure 7. Examination of Figure 7 makes
6 clear that there has been a strong positive relationship in Arizona between the level of
7 intrastate access charges and the level of intrastate long distance prices over the last
8 several years. In fact, in each year of the data the average price paid by AT&T for
9 intrastate access went down, and so did the average price charged for intrastate long
10 distance service.

Figure 7

AT&T's Intrastate Toll Price versus Access Cost in Arizona

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1 **Q: WHAT IS THE SIGNIFICANCE OF THE VERTICAL LINE?**

2 **A:** The vertical line in Figure 7 is the current average interstate access rate paid by AT&T in
3 Arizona. Hence, it is approximately the average rate that would be paid for intrastate
4 access if all LECs in Arizona were required to mirror their intrastate rates to their
5 interstate rates. You can see that reducing the LECs' intrastate access rates to interstate
6 levels would amount to a meaningful decrease in the average access rate paid by AT&T
7 in Arizona. And one can see visually that if the pattern of relationship between intrastate
8 access rates paid and intrastate long distance rates charged in Arizona is any indication,
9 one would expect the lower access rates to result in significantly lower prices in Arizona
10 for intrastate long distance service.

11 **Q: DO THE DATA TELL YOU ANYTHING ABOUT MAGNITUDE OF THE**
12 **DECREASE IN RATES IN ARIZONA THAT ONE COULD EXPECT?**

13 Yes. First, I used standard statistical techniques to estimate the relationship between the
14 intrastate access rates and the intrastate long distance prices in the 50 states. That
15 estimated relationship is depicted in Figure 6 as the red line through the data. The fact
16 that the data exhibit a positive and statistically significant relationship is not surprising
17 given that the relationship is apparent visually from Figure 6, and it what one would
18 predict on the basis of economic principles.

1 Using that estimated regression equation, I calculated what the relationship implies the
2 retail price for intrastate long distance service in Arizona would be if the intrastate access
3 rate were equal to interstate access rates in Arizona. I found that the implied price for
4 intrastate long distance service in Arizona would provide a reduction of 19 percent to 42
5 percent⁸⁵ from AT&T's current average intrastate long distance prices in Arizona.

6 **Q: WHAT DO YOU CONCLUDE FROM YOUR DATA ANALYSIS?**

7 **A:** It is clear that lower intrastate access rates are associated with lower intrastate long
8 distance prices. The effect is both visually apparent from the data, and statistically
9 significant. The relationship in the data imply that if intrastate access rates were reduced
10 to interstate levels in Arizona, one would expect reductions in AT&T's intrastate long
11 distance prices on the order of 19 percent to 42 percent. These are material reductions
12 that would provide a significant benefit to consumers and businesses in Arizona.

⁸⁵ The 19 percent is calculated as the percentage difference between AT&T's actual intrastate long distance price in 2008 and the price "predicted" by the regression model at the average interstate access rate paid by AT&T in Arizona. The 42 percent is the difference between the price "predicted" by the model at the actual intrastate access rates paid by AT&T in Arizona and the price "predicted" by the model at the average interstate access rate paid by AT&T. The first calculation assumes that the difference between the actual rate and the rate that goes through the regression line (the regression error) is random variation whose expected value is zero. The second calculation assumes that the difference between the actual rate and the rate that goes through the regression line (the regression error) is systematic to Arizona but unexplained by the model, and would therefore persist in its entirety at the lower access charge.

1 Q: **WHY WOULD A COMPANY VOLUNTARILY DECREASE ITS PRICES JUST**
2 **BECAUSE THE ACCESS CHARGES IT PAYS WENT DOWN?**

3 A: Companies do not decrease prices out of altruism but out of the desire and fiduciary
4 obligation to maximize their profits to the extent they can, given demand, cost, and
5 market conditions. When the incremental cost of producing something goes down, a
6 company *increases* its profits by *lowering* its prices, all else equal. The reason is that a
7 price reduction stimulates demand, and selling a bit more becomes profitable (when it
8 previously was not) when incremental costs are lower. This is an elementary economic
9 and mathematical principle that is true even for a company that faces no competition
10 whatsoever. It is the straightforward consequence of profit maximization, regardless of
11 competitive pressures on prices, that the profit maximizing response to a decrease in
12 incremental costs is a decrease in price, all else equal. Hence, regulators need not rely on
13 hopes of altruistic behavior or even on competitive pressures to expect declines in retail
14 prices as a result of access price reductions; and it is not surprising that the data
15 demonstrate declines in retail prices associated with access rate declines over the various
16 time periods, jurisdictions, carriers, and geographies studied. Even a company that is
17 wholly insulated from competition would rationally decrease prices if its incremental
18 costs fell.

19 Of course, long distance service is highly competitive, so competitive pressures reinforce
20 the incentive to lower prices when incremental costs fall. A company experiencing a

1 decline in incremental cost enjoys an opportunity to compete more effectively and still
2 cover costs by lowering its prices. This induces other competitors to lower their prices as
3 well. A company decreases its price in response to a competitor out of an imperative to
4 maintain its market position at previous levels or even to survive in competition with a
5 lower-priced rival. Hence, incentives for profit maximization and competitive pressures
6 both work in the same direction to induce companies to decrease prices when their
7 incremental costs fall, and they reinforce one another. It is undoubtedly the case that the
8 decreases in long distance prices that have occurred as the result of access price declines
9 have been the result of these combined economic pressures, and they can be expected to
10 be effective going forward as well.

11 **B. Excessive Access Rates Also Harm Consumers by Causing Them to Use Less**
12 **Long Distance Service Than They Would Choose at More Efficient Prices, and by**
13 **Raising the Costs of Businesses Operating In Arizona**

14 **Q: IN WHAT OTHER WAYS DO EXCESSIVE ACCESS PRICES HARM**
15 **CONSUMERS?**

16 **A:** I have explained that higher access charges result in higher retail prices for long distance
17 services. Those higher prices not only cause consumers to pay more for service—the
18 direct effect I just discussed—but also cause consumers to use less of the service. The
19 discouraging effect of higher prices is a normally good thing—an efficient effect of the
20 price system—but only when prices reasonably reflect the underlying costs of producing

1 a product or service. Prices then are the means by which consumers' decisions about
2 how much to consume of a given product or service reflect the underlying cost to society
3 of the inputs used to create or provide that product or service. If, however, the price of a
4 service far exceeds its real underlying cost, consumers will restrict their usage more than
5 is justified by the societal cost of producing the product, and consumers thereby forgo
6 consumption and enjoyment unnecessarily. This distortion of consumption as a result of
7 distorted prices is known as "allocative inefficiency," and the loss of economic well-
8 being that results is what economists refer to as a social "deadweight loss" to the
9 economy. Allocative efficiency is reduced, and consumers are harmed, when regulation
10 causes prices to be higher than prices that would more closely reflect cost-causation.

11 **Q: IS THERE EVIDENCE THAT CONSUMERS DO IN FACT USE LONG**
12 **DISTANCE SERVICE LESS AT HIGHER PRICES?**

13 **A:** Yes. There is a considerable amount of literature demonstrating that usage of long
14 distance is lower at higher prices and higher when prices are lower. The extent to which
15 consumers respond to prices (if at all) is measured by the "elasticity" of demand. Several
16 studies have quantified the price elasticity of demand for toll services for different time
17 periods and for different jurisdictions (interstate, international, intrastate), and all have

1 found that decreases in long-distance prices cause increases in the consumption of long
2 distance services, and vice versa.⁸⁶

3 **Q: WHAT DO THESE RESEARCH RESULTS MEAN IN PRACTICAL TERMS?**

4 **A:** They mean that consumers change their calling habits by calling more when long
5 distance prices go down. Years ago, for example, when long distance prices were many
6 times what they are today, long distance calls were a luxury used only very sparingly.
7 Long-distance calls were tightly rationed in households, the length of calls was closely
8 monitored, and when the monthly bill arrived loved ones often argued about whether they
9 were talking too long or making too many long-distance calls. Today, the entire
10 mentality towards long-distance calling has changed as prices have declined

⁸⁶ See, Lester D. Taylor, TELECOMMUNICATIONS DEMAND IN THEORY AND PRACTICE, (Dordrecht: Kluwer Academic Publishers, 1994), pp. 129-148 and 296-314 and sources cited therein. See, also, Paul N. Rappoport and Lester D. Taylor, "Toll price elasticities estimated from a sample of U.S. residential telephone bills," *Information Economics and Policy* 9 (1997), pp. 51-70; Donald J. Kridel, "A Consumer Surplus Approach to Predicting Extended Area Service (EAS) Development and Stimulation Rates," *Information Economics and Policy* 3 (1988), pp. 379-390; T.W. Appelbe, C.R. Dineen, D. L. Solvason, and C. Hsiao, "Econometric Modelling of Canadian Long Distance Calling: A Comparison of Aggregate Time Series Versus Point-to-Point Panel Data Approaches," *Empirical Economics* 17 (1992), pp. 125-140; Lester D. Taylor, "Competitive Own- and Cross-Price Elasticities in the Intralata Toll Market: Estimates from the Bill Harvesting II Database," Whitepaper (Fall 1996); Simran K. Kahai, David L. Kaserman, and John W. Mayo, "Is the 'Dominant Firm' Dominant? An Empirical Analysis of AT&T's Market Power," *Journal of Law and Economics* 39, (October 1996), pp. 499-517; Donald J. Kridel, Paul N. Rappoport, and Lester D. Taylor, "IntraLATA long-distance demand; carrier choice, usage demand and price elasticities," *International Journal of Forecasting* 18 (2002), pp. 545-559; Armando Levy, "A generalized additive Tobit model: An application to telecommunications demand," *Empirical Economics* 28 (2003), pp. 3-22; Clement G. Krouse and Jongsur Park, "Competition in the Interexchange Telecommunication Market," *Journal of Law and Economics* XLVI (April 2003), pp. 85-101; Michael R. Ward and Glenn A. Woroch, "Usage Substitution between Mobile Telephone and Fixed line in the U.S.," Whitepaper (May 2004); and David E. Burnstein, "An Examination of Market Power in the Intrastate Long-Distance Telephone Service Markets: Evidence from a Natural Experiment," *Journal of Law and Economics* XLVIII (April 2005), pp. 149-171.

1 precipitously, not only for wireline calling but also for wireless and VoIP calling, and
2 alternatives to voice telephony, such as texting, email, social networking sites, instant
3 messaging, and other services, so that long distance communications are no longer
4 viewed as a luxury that must be closely rationed. Rather, consumers are more likely to
5 consider which phone or other technology they will use for a given communication,
6 based on the relative prices, convenience, and other characteristics—a phenomenon I will
7 discuss shortly.

8 **Q: ARE THERE OTHER WAYS THAT EXCESSIVE INTRASTATE ACCESS**
9 **CHARGES HARM CONSUMERS?**

10 **A:** Yes. Residential consumers are not the only customers who pay long distance rates—
11 business customers in Arizona pay them also. When long distance prices are higher and
12 business customers must pay the higher rates, their cost of doing business is higher in
13 turn. This additional cost borne by businesses must either be passed through in the form
14 of higher prices paid by the customers of those businesses, or in the form of contractions
15 of the business.⁸⁷ Both of these effects harm not only the Arizona businesses themselves

⁸⁷ A survey of small businesses conducted by TeleNomic Research found that small businesses spend a considerable amount, on average \$543 per month, for telecommunications services. The survey also determined that the cost burden of telecommunications services was higher for very small businesses. For example, firms with 0 to 4 employees were estimated to spend \$82.81 per employee for local and long distance telephone service, while firms with 5 to 9 employees were estimated to spend \$50.18 per employee and firms with 10 to 499 were estimated to spend \$20.99 per employee. See, Stephen B. Pociask, "A Survey of Small Businesses' Telecommunications Use and Spending," TeleNomic Research, LLC, (March 2004).

1 but also their customers, who ultimately must face higher prices for a variety of goods
2 and services.

3 **C. Excessive and Disparate Access Rates Harm Competition**

4 **Q: HOW DO THE EXCESSIVE AND DISPARATE INTRASTATE ACCESS RATES**
5 **IMPOSED UNDER THE CURRENT ACCESS REGIME HARM**
6 **COMPETITION?**

7 **A:** The current access regime significantly distorts competition across technologies. For
8 example, the tremendous disparities in access rates paid by wireline carriers versus
9 wireless carriers create a pronounced, and artificial, competitive advantage for wireless
10 long distance services. As I explained earlier, for intrastate calls that are within an MTA,
11 wireless companies pay for terminating access at reciprocal compensation rates, even if
12 the call crosses a local calling area or LATA boundary. The same call on the wireline
13 network would trigger intrastate originating and terminating access rates, which in
14 Arizona are between [BEGIN HIGHLY CONFIDENTIAL INFORMATION] [REDACTED]
15 [REDACTED] [END HIGHLY CONFIDENTIAL INFORMATION] or even more times higher
16 on average than the intraMTA rates paid by wireless companies to the same LECs, as
17 shown in Tables 1, 2 and 3 above. Put differently, for wireline calls, the calling area in
18 which (low) reciprocal compensation rates rather than (high) access rates apply is the
19 LEC's (relatively small) traditional wireline local calling area. For wireless calls, the
20 situation is reversed. The calling area in which (low) reciprocal compensation rates

1 rather than (high) access rates apply is the (relatively large) MTA. This difference in
2 regulatory treatment has a profound effect on the costs of interconnection for the two
3 kinds of carriers, because MTAs comprise far larger geographic areas than do wireline
4 local calling areas, as I demonstrated earlier.

5 Q: **WHAT IS THE EFFECT ON COMPETITION BETWEEN WIRELESS AND**
6 **WIRELINE SERVICES OF THE VAST DIFFERENCES BETWEEN LOCAL**
7 **CALLING AREAS AND MTAS?**

8 A: To see the economic effect of these differences between MTAs and local calling areas,
9 consider a call from an ILEC customer in Phoenix to an ILEC customer in Parker, and
10 suppose the customer's long distance company is AT&T. Because Phoenix and Parker
11 are in different local calling areas in Arizona, AT&T would pay approximately [BEGIN
12 **CONFIDENTIAL INFORMATION**] [REDACTED] [END **CONFIDENTIAL**
13 **INFORMATION**] in originating intrastate switched access charges to the ILEC serving
14 Phoenix (Qwest) and [BEGIN **HIGHLY CONFIDENTIAL INFORMATION**] [REDACTED]
15 [END **HIGHLY CONFIDENTIAL INFORMATION**] in terminating intrastate
16 switched access charges to the ILEC serving Parker (Verizon), for each minute of the call
17 (see Table 1). If, instead, the customer in Phoenix placed the call to the same telephone
18 number from her wireless phone, the wireless carrier would pay nothing in originating
19 access (but would incur the costs of call origination), since wireless companies self-
20 provide long distance service, and would pay the called party's ILEC provider a

1 reciprocal compensation rate of [BEGIN HIGHLY CONFIDENTIAL
2 INFORMATION] [REDACTED] [END HIGHLY CONFIDENTIAL INFORMATION] per
3 minute to terminate the call, because Phoenix and Parker are in the same MTA (see Table
4 3). So the wireless carrier would pay less than [BEGIN HIGHLY CONFIDENTIAL
5 INFORMATION] [REDACTED] [END HIGHLY CONFIDENTIAL INFORMATION] to
6 the LEC for interconnection, while AT&T would pay [BEGIN HIGHLY
7 CONFIDENTIAL INFORMATION] [REDACTED] [END HIGHLY
8 CONFIDENTIAL INFORMATION] in access charges per minutes—more than 25
9 times what the wireless carrier would pay. The wireless company, therefore, could offer
10 a substantially lower price to its customers for the same call from Phoenix to Parker than
11 it could if it had to pay the same intrastate access rates that AT&T must pay. These vast
12 differences in rates charged by the local exchange company for the same access
13 functionality substantially disfavors the wireline IXC and confers a competitive
14 advantage on its wireless competitor in providing long distance services for no reason
15 related to their relative efficiencies or value of service provided. When some businesses
16 are favored by regulatory rules that are unrelated to underlying costs of doing business,
17 the detrimental effect on the economy is known as “productive inefficiency.” The
18 example illustrates that the regulatory distortions in the access regime place wireline long
19 distance providers at a significant competitive disadvantage. Those distortions, and the

1 resulting productive inefficiency, would be reduced (though not eliminated) by adopting
2 a mirroring policy for intrastate access rates.⁸⁸

3 **Q: HOW DO THESE COST DIFFERENCES AFFECT CONSUMERS ON A DAY-**
4 **TO-DAY BASIS?**

5 A: These cost differences affect consumers' choicemaking behavior with regard to the
6 different forms of communications available to them. Nowadays, people think nothing of
7 making long-distance calls on their wireless phone. This is no surprise, since wireless
8 carriers, who incur a per-minute cost for all calls that is a small fraction of the per-minute
9 cost that wireline carriers incur for non-local calls have been pioneers in innovative, all-
10 distance calling plans offering buckets of "anytime, anywhere" minutes. Moreover,
11 consumers have options for instantaneous long-distance communications that avoid the
12 PSTN entirely, such as email, instant messaging, social networking, and Skype-to-Skype
13 calling, and whose providers bear no message-based interconnection charges to provide
14 those services. The absence of access charges allows these providers to offer "free"
15 alternatives for long distance communications to consumers that have access to the
16 Internet—that is, these providers receive no money from customers for the
17 communications service. Consumers respond to this array of options by weighing both
18 the relative prices of their options and the characteristics of the available services (e.g.,

⁸⁸ As I explain later, the reform proposed by AT&T in this proceeding is an important step in the right direction and will benefit consumers and businesses in Arizona. However, it does not reduce intrastate access rates all the way to efficient levels and therefore should be viewed as a step in an ongoing effort.

1 convenience, call quality, voice versus text, and so forth) to decide on a case-by-case
2 basis which option they will choose. The artificially high price of wireline long distance
3 service, driven by artificially high access rates, discourages use of the wireline long
4 distance service in favor of other technologies relative to what that use would be if
5 wireline long distance prices were not so distorted by inflated access charges.⁸⁹

6 For example, a mother may prefer to keep in touch with her child at college on the
7 wireline phone, because she may prefer its service or handset characteristics to wireless
8 or computer-to-computer calling. However, that family may nevertheless keep in touch
9 largely or entirely by wireless phone and/or computer-to-computer calling (as well as
10 email, instant messaging, and other communications options) because of the lower price.
11 The fact that the family is discouraged from communicating on the wireline network by
12 artificially high wireline long distance prices is an economic harm or "social welfare
13 loss" associated with those distorted prices. The dollar magnitude of the harm can
14 conceptually be measured as the forgone value that the family would have enjoyed from
15 the wireline call that it would have otherwise chosen. More generally, the economic

⁸⁹ See, for example, Michael R. Ward and Glenn A. Woroch, "Usage Substitution between Mobile Telephone and Fixed line in the U.S.," Working Paper, May 2004, pp. 5, 11, 12, and 17 (Table 4). The authors construct a data set by aggregating household observations into a sample of observations at the LATA level, across ten quarters (3-month periods) from July 1999 to December 2001. The authors estimate the price effects on different types of wireline and wireless toll usage in the U.S. The authors produce six different estimates of the effect of wireline prices on wireless toll usage that range from -0.03 to 0.21. Because of data issues that limited the sample size employed for certain estimates, the authors indicate they have "most confidence" (p. 12) in two

1 harm from the distorted prices is the foregone value to all consumers from calls they did
2 not make, but otherwise would have made, and calls they would have preferred to make
3 on the wireline network, but made some other way due to the price distortion.

4 **D. Excessive Access Rates Distort Investment**

5 **Q: HOW DO EXCESSIVE ACCESS RATES HARM EFFICIENT INVESTMENT**
6 **INCENTIVES?**

7 **A:** Investment incentives are driven by the prospect for future return on the investment. The
8 prospects for future return on an investment depend, in turn, on the desire and willingness
9 of consumers to use the services supported by that investment, which depend on the
10 prices consumers must pay for the services. The chain of causation is as follows:
11 artificially high access prices cause long distance companies to maintain higher retail
12 prices to cover those costs;⁹⁰ higher long distance prices discourage consumers from
13 using the wireline network to make long distance calls, driving usage below what it
14 would otherwise be;⁹¹ at higher costs and lower usage, the current and anticipated future

of the six estimates, which range from 0.11 to 0.21. These results indicate that there is a positive relationship between wireline prices and wireless demand.

⁹⁰ See evidence in Section VI.A.

⁹¹ See evidence in Section VI.B.

1 value of the network to investors is lower; investment in the wireline long distance
2 network is discouraged.⁹²

3 Incentives for future investment are of particular importance because investment is long-
4 lived, and distorted investment decisions therefore harm consumers and the economy not
5 only today but for years into the future. The effects of distorted prices on investment and
6 innovation decisions are known as dynamic inefficiency, because investment and
7 innovation have long-lived ("dynamic") effects. An economy makes the most efficient
8 use of its resources when investment decisions reflect the relative efficiencies of and
9 demands for different technologies, businesses, and uses. Distorted prices and the
10 resulting distorted investment decisions create dynamic inefficiency in the economy.

11 When prices distorted by regulatory policy discourage use of a particular service or
12 network, investment in that service is dampened, all else equal, because the investors
13 would expect a lesser return or profit than they would absent the distortions. Put simply,
14 the lower the demand for a service, the lower the incentive to invest in the facilities that
15 provide it, all else equal. That is efficient from a social perspective if the loss of
16 customers or lack of demand is the result of competition on the merits. However, if
17 demand is weaker than it would otherwise be due to prices distorted by regulation,

⁹² It is a standard economic tenet that investment into an asset is discouraged if the net present value of the asset is decreased. See Richard Brealey, Stewart Myers, and Franklin Allen, *PRINCIPLES OF CORPORATE FINANCE* (McGraw Hill/Irwin, 2006), Chapters 2, 5 and 6.

1 investment decisions are distorted as well, and the value of society's scarce investment
2 resources is not maximized. In particular, investment in the facilities and infrastructure
3 associated with the provision of wireline long distance service is discouraged below the
4 level that would have occurred if demand were able to respond to prices that more
5 closely reflected the true social costs. This dynamic inefficiency harms consumers today
6 and in the future. Reducing the distortion by lowering excessive access prices and
7 decreasing the disparities among access rates would improve dynamic efficiency by
8 creating investment incentives that more closely align with consumer preferences and
9 social costs.

10 Investors must decide how to allocate their investment funds across competing
11 technologies, firms, and industries. When regulatory distortions are reduced, investment
12 dollars can be allocated in closer relation to the underlying value of the different uses, as
13 seen through the eyes of consumers. Consumers therefore benefit when dynamic
14 efficiency is increased.

15 **E. Excessive Access Rates Create Wasteful and Distortionary Arbitrage Behavior**

16 **Q: ARE THERE OTHER DISTORTIONARY EFFECTS OF EXCESSIVE ACCESS**
17 **CHARGES?**

18 **A:** Yes. Excessive access charges create artificial arbitrage opportunities by which access
19 providers can exploit the differences between costs and regulated prices and exploit the

1 access payers in the process. When access charges substantially exceed cost, there is
2 money to be made by receiving those fees. For example, suppose it cost 1¢ per minute to
3 provide access but the access charge were 10¢ per minute (I chose these round numbers
4 purely for ease of illustration, but access charges are often several multiples of cost).
5 Then it would be very lucrative for an access provider to identify or even create a
6 business that receives a large number of phone calls (a chat line is one example) and then
7 sets itself up as the local exchange carrier (and thus the point of access) for that business.
8 The chat line would generate a margin for the access provider of 9¢ per minute for every
9 minute received, in my example. The access provider might give the chat line an
10 extremely low price for local service, or even pay the chat line a fee or share of the
11 access margin to make the chat line its customer. In turn, the chat line might pay end
12 users a portion of that margin to encourage them to call the chat line to drum up more
13 access fees.

14 Competition to become a chat line's LEC can drive profits out of the LEC's business
15 (via, for example, lower prices or bigger transfer payments to the chat line provider), but
16 would nevertheless not drive *access* rates down. Lowering its access rates would not put
17 the LEC in any better position to attract customers such as chat lines—on the contrary,
18 LECs with higher access rates could provide even bigger retail discounts (or kickbacks)
19 to chat line providers. Hence, retail competition would simply force a transfer of the

1 arbitrage profits from the LEC to the chat line and/or its customers, without disciplining
2 the access rates. It is no surprise that these arbitrage-based businesses are sometimes
3 referred to as "call-pumping" schemes, an apt term because they act as a siphon from
4 access payers subject to, and unable to avoid, the excessive access charges.

5 **Q: ARE YOU AWARE OF ANY OTHER ARBITRAGE SCHEMES THAT ARISE**
6 **FROM THE CURRENT ACCESS/INTERCONNECTION REGIME OF HIGHLY**
7 **DISPARATE RATES?**

8 **A:** Yes. The significant disparity between the rates for interstate access and intrastate access
9 creates an incentive for terminating LECs to misclassify traffic so that they can bill the
10 higher intrastate rather than interstate rates; and by the same token, it creates an incentive
11 for access payers to misclassify traffic so that it is billed at the lower interstate rates.
12 Similarly, the disparate access rates and reciprocal compensation rates create an incentive
13 for access payers to misclassify traffic so that it appears to be local traffic rather than
14 long distance traffic. The incentive for access payers to misclassify traffic is known as
15 the "phantom traffic" problem. Analysts have estimated the amount of lost revenues to
16 access providers due to phantom traffic to range from \$600 million to \$2 billion
17 annually.⁹³ The incentive to avoid excessive access rates by misclassifying traffic so that

⁹³ Letter from Karen Brinkman of Latham and Watkins, LLC on behalf of a group of LECs to the FCC re: WC Docket 01-92, Intercarrier Compensation – Notice of *Ex Parte* Presentation, July 1, 2005, attaching a presentation by Balhoff & Rowe, LLC (which found a \$600 million loss to rural carriers); Letter from Joseph Douglas of NECA to the FCC re: Intercarrier Compensation Reform, Docket Number 01-92, *Notice of Ex Parte Presentation*, May 2, 2007, attaching a NECA presentation that cites estimates by Raymond James (which

1 it is charged a lower price for the same terminating functionality is another artifact of the
2 differential in prices that does not reflect a differential in the functionality provided.

3 All of the resources devoted to establishing mechanisms for identifying whether wireline
4 traffic is interstate or intrastate, ensuring that traffic is not intentionally or accidentally
5 misclassified, establishing traffic identification rules, and engaging in disputes over
6 traffic identification, "phantom traffic," and "call pumping," are a deadweight loss to the
7 economy that would be decreased or avoided if interstate and intrastate access rates were
8 the same.

9 **VII. The Commission Should Order ILECs and CLECs in Arizona to Decrease**
10 **Intrastate Access Rates in Order to Increase Consumer Welfare, Enhance**
11 **Competition, Encourage Efficient Investment, and Discourage Socially Wasteful**
12 **Arbitrage Opportunities (Issues 1 and 2)**

13 **A. Ordering ILECs to Decrease Intrastate Access Rates to Interstate Levels Will**
14 **Enhance Economic Efficiency by Bringing Access Rates Closer to Cost**

15
16 **Q: SHOULD THE COMMISSION ORDER ILECS IN ARIZONA TO DECREASE**
17 **INTRASTATE ACCESS RATES TO INTERSTATE LEVELS?**

18 **A: Yes.**

estimates a \$2 billion loss to the industry overall) and Balhoff & Rowe (which estimates a \$600 million loss to rural carriers).

1 Q: WHY?

2 A: In light of the myriad disparities in the current access regime that I have discussed, and
3 the fact that intrastate access rates in Arizona are the holdover of the legacy system that
4 has been substantially revised and reformed for all other interconnection charges,
5 decreasing intrastate access rates to interstate levels would benefit consumers and
6 promote competition on the merits. As an economic matter, prices for switched access
7 service should not be higher than the cost of providing access service.⁹⁴ As I have
8 explained, however, current intrastate rates are an artifact of the legacy regulatory policy
9 of using access rates set well above cost to cross-subsidize local service. Cross-subsidy
10 mechanisms are incompatible with the policy goal of promoting consumer welfare and
11 advancing competition on the merits, by which the success and failure of competitors are
12 determined on the basis of their relative costs, efficiencies, and quality of services, and
13 not by regulatory asymmetries. All of the evidence of which I am aware indicates that
14 decreasing ILECs' intrastate switched access rates to interstate levels would bring them
15 closer to cost as well as lessen the disparities across technologies, jurisdictions, and types
16 of calls. Excessive access prices harm consumers, and highly disparate access prices
17 distort and harm competition—and thereby also harm consumers, as I discussed earlier.

⁹⁴ See, for example, Mark Armstrong, "The Theory of Access Pricing and Interconnection," in *Handbook of Telecommunications Economics*, ed. M.E. Cave et al., Vol.1, (Amsterdam: Elsevier Science B. V., 2002), pp. 356-379, and sources cited therein. In addition, some economists argue that the efficient interconnection price is zero (i.e., "bill and keep"). See, e.g., Patrick DeGraba, "Bill and Keep at the Central Office as the Efficient

1 Further, these prices distort investment decisions and create incentives for regulatory
2 arbitrage that exploits access payers and wastes social (i.e., Arizona's) resources.

3 **Q: WHAT IS THE BASIS FOR YOUR OPINION THAT DECREASING ILECS'**
4 **INTRASTATE SWITCHED ACCESS RATES TO INTERSTATE LEVELS**
5 **WOULD BRING THEM CLOSER TO THE ILECS' COSTS?**

6 **A:** My opinion is based on my analysis of the overall pattern and history of access rates and
7 access reform. As I discussed above, it is clear that interstate switched access rates were
8 set well above the ILECs' costs. Intrastate rates remain much higher than the
9 corresponding interstate rates and higher still than (purportedly) cost-based rates for
10 reciprocal compensation, even though all of these rates are charged for the same function.
11 Hence, reducing intrastate switched access rates would bring them closer to the ILECs'
12 costs. This conclusion is consistent with the FCC's investigation and analysis to
13 establish rates for terminating ISP-bound traffic and reciprocal compensation, including
14 wireless traffic; the FCC's analysis in the course of interstate access reform; and the
15 participation of Qwest, Verizon, and other ILECs in advocating the interstate rates that
16 are essentially the ones in effect today.

Interconnection Regime," Federal Communications Commission, OPP Working Paper No. 33, (Dec. 2000) ¶ 2, n. 3 and citations in Appendix C to the *Intercarrier Compensation Reform FNPRM*.

1 Q: COULD YOU PLEASE DESCRIBE THE FCC'S ANALYSES BY WHICH ONE
2 CAN CONCLUDE THAT INTERSTATE ACCESS RATES AT LEAST COVER
3 COSTS, AND THEREFORE INTRASTATE ACCESS RATES SIGNIFICANTLY
4 EXCEED COST?

5 A: The FCC established reciprocal compensation rates for terminating ISP-bound traffic to
6 start at 0.15¢ per minute and gradually decrease over time to 0.07¢ (that is, 15/100 of a
7 penny and 7/100 of a penny, respectively) per minute.⁹⁵ These reciprocal compensation
8 rates are many times lower than the current per minute rate that ILECs in Arizona charge
9 a landline toll carrier to complete an interstate toll call. The FCC concluded that these
10 rates (which are well below the current interstate access rates) were sufficient to recover
11 costs:

12 These rates reflect the downward trend in intercarrier compensation rates
13 contained in recently negotiated interconnection agreements, suggesting
14 that they are sufficient to provide a reasonable transition from dependence
15 on intercarrier payments while ensuring cost recovery.⁹⁶

16 In the *CALLS Order*, as I discussed previously, the FCC adopted the access reform
17 proposal set forth by a consortium of local and long distance providers. The current
18 interstate access rates charged by Qwest, Verizon, and Citizens, which are much lower
19 than their intrastate rates in Arizona, are the result of the reductions imposed in the

⁹⁵ See, Order on Remand and Report and Order, *In the Matter of Implementation of the Local Competition Provisions in the Telecommunications Act of 1996 and Intercarrier Compensation for ISP-Bound Traffic*, before the Federal Communications Commission, FCC 01-131, (released April 27, 2001), (hereafter *2001 Order on Remand*), ¶¶ 8, 89, and footnote 177; and *2008 NPRM*, ¶ 3.

⁹⁶ *2001 Order on Remand*, ¶ 8.

1 *CALLS Order*. The FCC concluded that these “significant and immediate reductions to
2 per-minute carrier access charges will bring those rates *closer to cost* and translate into
3 lower per-minute long-distance rates.”⁹⁷ Not only did Qwest, Verizon and Citizens not
4 object to these interstate access charge reductions as being below cost or otherwise
5 confiscatory, they participated in bringing those reductions about—Verizon as a member
6 of the *CALLS* consortium that advocated for the price reductions, and Qwest and
7 Citizens as commenters that generally supported the proposal.⁹⁸ Similarly, ALECA
8 members’ current interstate rates are a result of the *MAG Order* that mandated interstate
9 rate reductions towards cost,⁹⁹ and as shown in Table 1, these rates are many times below
10 current intrastate rates. ALECA participated in this proceeding and supported the *MAG*
11 proposal.¹⁰⁰ To my knowledge, no ILEC in Arizona has sought review of its interstate
12 switched access rates on the ground that such rates were below cost.¹⁰¹ This lends

⁹⁷ *FCC CALLS Order*, ¶ 2. (Emphasis added.)

⁹⁸ *FCC CALLS Order*, footnote 1, and ¶ 48, footnote 67. See also Citizen Utilities Company Letter to the FCC re: *Ex Parte* Presentation in CC Docket Nos. 94-1, 96-45, 99-249 and 96-262 dated February 4, 2000; and Comments of Citizens Communications on the Revised Plan of the Coalition for Affordable Local and Long Distance Calling (“*CALLS*”), *In the Matter of Price Cap Performance Review for Local Exchange Carriers, Federal-State Joint Board on Universal Service, Low-Volume Long Distance Users, and Access Charge Reform*, before the Federal Communications Commission, CC Docket Nos. 94-1, 96-45, 99-249 and 96-262, March 31, 2000.

⁹⁹ *MAG Order*, ¶ 1.

¹⁰⁰ See Comments of the Arizona Local Exchange Carriers Association, *In the Matter of Multi-Association Group (MAG) Plan for Regulation of Interstate Services of Non-Price Cap Incumbent Local Exchange Carriers and Interexchange Carriers and Federal-State Joint Board on Universal Service et al.*, before the Federal Communications Commission, CC Docket Nos. 00-256 and 96-45 et al., February 26, 2001.

¹⁰¹ See, for example, Verizon Companies Responses to AT&T Discovery Request No. 2.15.

1 support to my conclusion that these incumbents' interstate access rates are at least
2 compensatory and that their intrastate rates are multiples of cost.

3 **B. CLEC Rates Should Be Capped at ILECs' Level in the Intrastate Jurisdiction**
4 **as They Are in the Interstate Jurisdiction Because CLECs Have Market Power**
5 **With Respect to Access to Their Customers**

6 Q: **SHOULD CLEC RATES BE CAPPED AT THE LEVEL OF THE ILEC WITH**
7 **WHICH THEY COMPETE?**

8 A: Yes.

9 Q: **BUT AREN'T CLEC ACCESS RATES DISCIPLINED BY COMPETITION?**

10 No, they are not. CLECs, as well as ILECs, possess market power in the provision of
11 switched access service. The fact that CLECs face extensive competition in the retail
12 market for *local exchange service* does not render the market for wholesale *switched*
13 *access service* competitive. This is because (i) IXC's cannot choose which local carrier
14 will originate or terminate their end users' calls; (ii) the party that does make the choice
15 of local carriers (the IXC's end-use customer or the person the customer calls) is not the
16 party that pays for switched access service (the IXC); and (iii) regulatory restrictions on
17 long distance price de-averaging, as well as logistical restrictions on doing so prevent
18 IXC's from charging a customer more for a particular call based on the access charges that
19 will apply to that specific call; therefore IXC's cannot send a price signal to the end users

1 to discourage them from choosing (or calling people who choose) LECs with high access
2 charges.

3 The FCC found in 2001 that these three factors enable CLECs to impose excessive access
4 charges¹⁰² and accordingly issued an order capping CLECs' interstate access rates. The
5 FCC noted that it did not want to

6 permit CLECs to continue to tariff the access rates they charge IXCs at the
7 level they see fit, without any guidelines to ensure their reasonableness.
8 [The FCC found] persuasive the IXC arguments that it is highly unusual
9 for a competitor to enter a market at a price dramatically above the price
10 charged by the incumbent, absent a differentiated service offering.¹⁰³

11 It decided, therefore, that "the reasonable rate for CLEC access service is the rate that the
12 ILECs are charging for similar service in the market."¹⁰⁴

13 Because the same conditions are present at the intrastate level, CLEC intrastate access
14 rates should be capped as well.

15 **C. AT&T's Proposal to Reduce Intrastate Access Rates to Interstate Levels Would**
16 **Not Bring Rates All the Way to Parity Across Technologies But Is a Positive Step**
17 **that Will Benefit Consumers and Businesses in Arizona**

¹⁰² The FCC found that CLEC market power "is attributable to" three specific factors: the fact that access charges are paid by the IXC rather than the person who decides who the access provider will be (the calling and called parties); the IXC has "little practical means of affecting the caller's choice of access provider;" and regulatory restrictions on retail rate deaveraging by IXCs. *CLEC Access Reform Order*, ¶ 31.

¹⁰³ *CLEC Access Charge Reform Order*, ¶ 37.

¹⁰⁴ *CLEC Access Charge Reform Order*, ¶ 61.

1 Q: IS AT&T'S PROPOSAL TO REDUCE INTRASTATE ACCESS RATES TO THE
2 ILECS' INTERSTATE LEVELS SUFFICIENT TO FULLY REFORM THE
3 DISTORTIONS ATTENDANT TO THE CURRENT ACCESS RATE SYSTEM?

4 A: No, but this proposal is best seen as a step in the right direction that can be completed
5 immediately. Interstate access rates themselves may well be far above the cost of
6 providing call termination and origination services, and continue to be the subject of
7 reform efforts. AT&T's proposal in this proceeding therefore does not fully drive access
8 rates to cost or to parity across technologies. But its proposal will increase consumer
9 welfare and promote competition, which are material benefits to the public that should
10 not be sacrificed in the pursuit of perfection. Nor should these steps, once taken, be
11 allowed to impede further progress on the dismantling of a regulatory structure that no
12 longer serves consumer interests.

13 VIII. Access Rate Reduction Should Be Part of a Holistic, Revenue Neutral Reform of the
14 Access Regime (Issues 3, 5, and 6)

15 Q: SHOULD THE COMMISSION GIVE CARRIERS THE OPPORTUNITY TO
16 EARN REVENUES THAT COMPENSATE FOR THE LOSS OF ACCESS
17 REVENUES THEY WOULD EXPERIENCE AS A RESULT OF INTRASTATE
18 ACCESS REFORM?

19
20 A: Yes, with respect to lines on which retail service rates are regulated. Those opportunities
21 may be provided either via the flexibility to increase retail rates or through universal

1 service funds. If a provider has been granted full pricing flexibility on certain lines (e.g.,
2 lines on which the customer is purchasing service in unregulated bundles), or on all lines,
3 there is no longer any justification for allowing excessive access rates to subsidize those
4 lines, and no compensation for reducing access rates on those lines is called for. The
5 provider would already have the opportunity to recover its local service costs in the retail
6 market as competition permits.

7 **Q: WITH RESPECT TO LINES THAT ARE SUBJECT TO RETAIL RATE**
8 **REGULATION, WHY IS IT SOUND PUBLIC POLICY TO PROVIDE AN**
9 **OPPORTUNITY FOR THE CARRIER TO RECEIVE REVENUES TO**
10 **COMPENSATE FOR THE ACCESS REVENUES THAT WOULD BE FORGONE**
11 **AS A RESULT OF ACCESS REFORM?**

12 **A:** As I have discussed, access rates were established 25 years ago as part of a cross-subsidy
13 scheme that was intended to permit ILECs to recover costs of residential basic local
14 exchange service (such as the cost of the local loop) through inflated access charges
15 imposed on IXCs, rather than through retail prices charged to end-user customers. This
16 was a regulatory quid pro quo in which regulated companies held retail prices below
17 compensatory levels in exchange for subsidy-producing access charges. With the
18 development of competition in local and long distance markets, particularly intermodal
19 competition, this policy is no longer viable and it is imperative that the Commission
20 facilitate competition on the merits and promote consumer welfare by bringing intrastate
21 access prices down to reduce to the maximum extent possible the implicit subsidies.

1 Bringing access prices down, however, without permitting a corresponding adjustment
2 upwards to the other price-capped services or seeking other means for carriers subject to
3 retail rate regulation to compensate for lost access revenues, would inappropriately
4 ignore the regulatory history that led to the current concerns with access prices. At the
5 same time, and for the same reasons, it is appropriate and consistent with sound policy
6 principles to reduce switched access rates as part of a holistic policy approach that
7 includes increases in the prices for other rate-regulated services or access to explicit
8 subsidies.

9 **Q: YOU TESTIFIED THAT THE COMMISSION COULD PROVIDE FOR**
10 **COMPENSATING REVENUES TO OFFSET REVENUES FORGONE AS A**
11 **RESULT OF COMMISSION-ORDERED ACCESS REFORM BY EITHER**
12 **PERMITTING INCREASES IN REGULATED RETAIL RATES FOR BASIC**
13 **LOCAL SERVICE, AND/OR BY PROVIDING INCREASED ACCESS TO**
14 **UNIVERSAL SERVICE FUNDS. IS ONE METHOD PREFERABLE TO THE**
15 **OTHER?**

16 **A:** Both methods have their merits and demerits. From a purely economic perspective, it is
17 generally superior to permit retail prices to adjust to levels that at least recover costs. But
18 from a policy perspective, the Commission may wish to support retail prices at
19 "affordable" levels, even if they are below cost in some areas, to promote the state's
20 universal service objectives.

1 Q: WHAT DO YOU MEAN BY "FROM A PURELY ECONOMIC PERSPECTIVE"?

2 A: The purely economic perspective is one in which overall consumer welfare is maximized.
3 Economic analysis focuses on the efficient use of resources to best respond to consumers'
4 tastes and preferences, which means the use of society's scarce resources in a way that
5 maximizes the overall consumer welfare that those resources can produce, given the
6 different ways that they could be deployed, and given consumers' desires.

7 Q: WHY IS IT GENERALLY SUPERIOR, FROM AN ECONOMIC PERSPECTIVE,
8 TO PERMIT PRICES TO ADJUST TO LEVELS THAT AT LEAST RECOVER
9 COSTS?

10 A: Prices affect the decisions that consumers make about what to consume and how much to
11 consume, as I have already discussed. Consumers make efficient decisions about what
12 goods and services to consume if the prices they face reflect the costs that society incurs
13 to supply them with those goods and services. Prices that reflect costs therefore
14 encourage a socially efficient allocation of society's resources to competing uses. Prices
15 that fall short of costs cause consumers to over-use those services, which is inefficient
16 because society's resources that could be used for something that would provide more
17 value to consumers are diverted to a less-valued use, to the detriment of consumers
18 overall.

19 Q: YOU HAVE EXPLAINED WHY, FROM A PURELY ECONOMIC
20 PERSPECTIVE, IT IS GENERALLY SUPERIOR TO ALLOW RETAIL PRICES
21 TO ADJUST TOWARD COST-BASED LEVELS THAN TO PERPETUATE

1 **SUBSIDIZED PRICES. ARE THERE REASONS THAT REGULATORS MIGHT**
2 **NEVERTHELESS REASONABLY CHOOSE TO PERMIT RECOVERY OF**
3 **SOME OF THE FORGONE ACCESS REVENUES THROUGH UNIVERSAL**
4 **SERVICE SUPPORT INSTEAD?**

5 A: Yes, there can be in certain circumstances. Regulators can face conflicting social policy
6 goals. One goal is certainly to maximize overall consumer (social) welfare. Another
7 goal, however, may be to promote universal service, even at the expense of overall social
8 welfare. To balance these objectives, AT&T proposes that (1) the Commission adopt a
9 benchmark mechanism by which the access reduction is partly compensated by retail rate
10 increases, with the rest funded by universal service support; and (2) Lifeline rates not
11 increase under the plan.¹⁰⁵

12 **Q: WHAT DO YOU MEAN BY "UNIVERSAL SERVICE"?**

13 A: By universal service, I mean that all consumers (or nearly all of them) have telephone
14 service available to them at reasonable rates.¹⁰⁶ The concept of universal service as a
15 social policy goal is based on the premise (which I am neither endorsing nor rejecting
16 here) that telephone service is of such unique importance to individuals' health and

¹⁰⁵ See Direct Testimony of Dr. Ola Oyefusi, *In The Matter of the Review and Possible Revision of Arizona Universal Service Fund Rules, Article 12 of The Arizona Administrative Code and In The Matter of the Investigation of the Cost of Telecommunications Access*, before the Arizona Corporation Commission, Docket Nos. RT-00000H-97-0137 and T-00000D-00-0672, December 1, 2009 (hereafter *Oyefusi Direct*).

¹⁰⁶ See, e.g., ARIZ. ADMIN CODE R14-2-1113 (establishing a universal service fund to "assure the continued availability of basic telephone service at reasonable rates"), and the Telecommunications Act of 1996, Sec. 254 (establishing, among others, the following principles of universal service: availability of quality services at "just, reasonable and affordable rates;" nationwide access to advanced telecommunications and information services; availability of such services to all consumers, including those in "low income, rural, insular, and high

1 welfare that we have an obligation as a society to ensure that all Americans have access
2 to it.

3 It is generally understood that 100 percent telephone penetration is not possible for a
4 variety of reasons, including the fact that at any point in time, some people are in the
5 process of moving or changing telephone providers, some may not want telephone
6 service at any price, and other factors. Nevertheless, overall telephone penetration
7 (accounting for wireless and other voice technologies) in the US today is very close to
8 the 100 percent policy ideal, and in Arizona today is 93 percent.¹⁰⁷

9 **Q: WHAT WOULD BE THE EFFECT ON OVERALL TELEPHONE**
10 **PENETRATION—AND THEREFORE UNIVERSAL SERVICE GOALS—OF**
11 **INCREASING PRICES OF REGULATED TELEPHONE SERVICES TO**
12 **RECOVER LOST ACCESS REVENUES DUE TO ACCESS REFORM?**

13 **A:** In principle, telephone penetration could go up, down, or stay the same. However, a
14 number of factors indicate that overall telephone penetration is likely to be resilient to
15 price increases on regulated local telephone service in Arizona, and overall penetration
16 could indeed increase. These factors include the facts that: (1) other means of
17 communications, such as wireline and broadband-based telephony are widely available,
18 and wireless penetration in Arizona is nearly universal; (2) an increase in wireline prices

cost areas" at rates that are "reasonably comparable" to those charged in urban areas; and access to advanced telecommunications services in schools, libraries and rural health care facilities.

1 due to access reform would be part of a holistic access reform policy that would be
2 expected to result in lower wireline long distance prices, as I discussed earlier, which
3 would tend to counterbalance increased prices for local exchange services; and (3)
4 explicit policies have been implemented in Arizona to protect low-income consumers
5 from any negative effects of increases to regulated rates.

6 For example, suppose for the sake of argument that allowing prices of basic regulated
7 local service to rise, holding all other prices constant, would cause a significant share of
8 customers to stop subscribing to regulated telephone service. In today's marketplace, this
9 would not imply that these customers would be without telephone service. These
10 customers might decide to rely instead on their wireless service, or, if they are among the
11 few in Arizona that do not have wireless service, begin subscribing to it; or they may
12 decide to switch instead to VoIP services, assuming such services are available in their
13 area.

14 Wireless service is certainly widely available in Arizona. As of June 2008, there were
15 4.9 million mobile wireless subscribers in Arizona, compared to 2 million seven years

¹⁰⁷ "Telephone Subscribership in the United States (Data through March 2009)," Alexander Belinfante, Industry Analysis and Technology Division, Wireline Competition Bureau, Federal Communications Commission, August 2009, Table 2.

1 ago, representing a growth of 145 percent,¹⁰⁸ and most of the state has wireless coverage,
2 with a significant portion of it being served by three or more wireless providers.¹⁰⁹
3 Nationwide, 20 percent of households have no wireline service and rely on wireless
4 service as their local telephone service.¹¹⁰ The percentage is even higher in the Phoenix
5 MSA, where, according to information provided in discovery by Qwest, the percentage of
6 wireless-only households (i.e., those with wireless but no traditional wireline service) has
7 reached 25 percent.¹¹¹ Indeed, 97 percent of the population in Arizona over the age of 15
8 has a wireless phone.¹¹² Studies have also found that lower income customers are more
9 likely than are higher income customers to “cut the cord” and have wireless service only,
10 rather than have wireline service and no wireless service.¹¹³

¹⁰⁸ “Local Telephone Competition: Status as of June 20, 2008,” Federal Communications Commission, Industry Analysis and Technology Division, Wireline Competition Bureau, July 2009 (hereafter *FCC Local Competition Report*), Table 14.

¹⁰⁹ Twelfth Report, *In the Matter of Implementation of Section 6002(b) of the Omnibus Budget Reconciliation Act of 1993 and Annual Report and Analysis of Competitive Market Conditions With Respect to Commercial Mobile Services*, before the Federal Communications Commission, FCC 08-28, (released February 4, 2008), Map B-7, p. 140.

¹¹⁰ Stephen J. Blumberg and Julian V. Luke, “Wireless Substitution: Early Release of Estimates from the National Health Interview Survey, July-December 2008,” Centers for Disease Control and Education (CDC), May 6, 2009.

¹¹¹ Qwest Supplemental Response to AT&T Discovery Request No. 3-8, p. 3 of Attachment A. This is consistent with a study based on 2007 data that found that the percentage of wireless-only households in Arizona was higher than the national percentage (18.9% and 14.7%, respectively). See Stephen J. Blumberg and Julian V. Luke, “Wireless Substitution: State-level Estimates from the National Health Interview Survey, January–December 2007,” *National Health Statistics Reports*, Number 14, March 11, 2009.

¹¹² The percentage of all residents in Arizona with a wireless phone is 76 percent. *FCC Local Competition Report*, Table 14; and U.S. Census Bureau, “2008 American Community Survey, Selected Population Profile in the United States – Arizona.”

¹¹³ See, for example, Charles S. Golvin *et al.*, “Cord-Cutting Reaches One In 20 Mobile Households,” Forrester Research, May 5, 2005, p. 2; Keith Mallinson, “Personal Wireless Calling Surpasses Wireline Calling: A

1 Broadband service is also widely available in Arizona. According to the FCC's most
2 recent report, as of June 2008, all Zip Codes in Arizona had at least three providers of
3 high-speed service, and 57 percent of Zip Codes had ten or more.¹¹⁴ The FCC also
4 reports that in Arizona, 84 percent of homes where ILECs offer local telephone service
5 have xDSL available, and 99 percent of homes where cable providers offer service have
6 broadband cable service available.¹¹⁵

7 If customers switch from wireline to wireless service (or simply drop their wireline
8 service and retain the wireless service they already have); or switch to broadband based
9 telephony (as part of a broadband package, for example, this would not decrease overall
10 telephone penetration and would therefore not damage universal service goals. It would
11 be a reflection of consumer preferences, when consumers are able to face prices that
12 more fully reflect actual costs. Of course, if, in some areas, no wireless, broadband, or
13 other alternative services were available, and if the increase in wireline local service
14 prices (all else equal) were enough to make a significant number of customers choose not
15 to buy any telephone service at all, that might affect the goal of universal service.

Wireless Substitution Update," Yankee Group Analyst Report, August 2005, p. 2; and Amy Cravens, "Cutting the Cord: Consumer Wireline Erosion," In-Stat Analyst Report, December 2005, p. 2.

¹¹⁴ "High-Speed Services for Internet Access: Status as of June 30, 2008," Federal Communications Commission, Industry Analysis and Technology Division, Wireline Competition Bureau, July 2009 (hereafter *FCC Broadband Report*), Table 17.

¹¹⁵ *FCC Broadband Report*, Table 14.

1 The foregoing discussion, however, accounts for only half of the picture. If local service
2 prices are increased to compensate for access rate reductions, the access rate reductions
3 themselves would be expected to cause long distance prices to decline, as I have already
4 explained. Lower wireline long distance prices would stimulate demand not only for
5 wireline long distance service, but for access to the wireline network (i.e., basic local
6 service), all else equal. The net effect of increased local exchange prices and reduced
7 long distance prices could increase demand not only for long distance service but also for
8 local exchange access—therefore leading to *increased* wireline telephone penetration.

9 Q: IS THERE EVIDENCE THAT ACCESS RATE REBALANCING—I.E.,
10 REDUCED ACCESS RATES AND COMPENSATING INCREASED LOCAL
11 SERVICE RATES—CAN IN FACT CAUSE TELEPHONE PENETRATION TO
12 INCREASE?

13 A: Yes. In a study published in the *American Economic Review* by economist Jerry
14 Hausman and colleagues Timothy Tardiff and Alexander Belinfante,¹¹⁶ the authors
15 analyze telephone penetration and prices from 1984 to 1990, and find that “an increase in
16 basic [retail local] access prices combined with a decrease in long-distance toll prices

¹¹⁶ Jerry Hausman, Timothy Tardiff, and Alexander Belinfante, “The Effects of the Breakup of AT&T on Telephone Penetration in the United States,” *The American Economic Review*, 83:2 (May 1993) (hereafter *Hausman et al. 1993*), pp. 181-182. The authors estimate the effect on telephone penetration from changes in the price for local service and the prices for interstate and intrastate (intraLATA and interLATA) toll services. Employing a panel data set from 1984 to 1988 of up to 500 different geographic locations in the U.S., the authors estimate a binary logit model where the left-hand-side (dependent) variable is the proportion of households with telephone service and the right-hand-side (independent) variables are telephone prices and demographic variables of households. The authors find that at 1990 average U.S. prices and penetration levels, the own-price elasticity for local service is -0.005, whereas the cross-price elasticity of demand for local service

1 (via a decrease in long-distance access prices) could well lead to an *increase* in telephone
2 penetration.”¹¹⁷ They conclude that “the evidence ... tends to show that increased
3 penetration [that occurred during the time period studied] resulted in part from the
4 combined effect of higher monthly basic [retail local] access charges and lower long-
5 distance prices” during this period.¹¹⁸

6 **Q: ARE THERE ANY SAFEGUARDS IN ARIZONA FOR LOW-INCOME**
7 **CUSTOMERS TO RECEIVE TELEPHONE SERVICE IF RETAIL PRICES FOR**
8 **LOCAL EXCHANGE SERVICE WERE TO RISE?**

9 **A:** Yes. Pursuant to Arizona Statute, heads of household that are 65 or older and have a
10 household income at or below the poverty level are eligible for a telecommunications
11 service assistance program. LECs are required to provide assistance to eligible recipients
12 in the form of a credit of 17 percent on their charges.¹¹⁹ The Arizona Department of
13 Economic Security administers additional telephone discount programs through
14 agreements with Qwest for households meeting certain poverty criteria, such as the
15 Telephone Assistance Program for the Medically Needy, which pays for basic telephone
16 service for individuals who have a medical need for a telephone in the home; and the
17 Lifeline Telephone Discount Program, which provides a discount of \$8.04 to the basic

is -0.0086 with respect to the price of intraLATA toll, -0.0019 with respect to the price of intrastate interLATA toll, and -0.0055 with respect to the price of interstate toll.

¹¹⁷ *Hausman et al. 1993*, p. 182.

¹¹⁸ *Hausman et al. 1993*, p. 183.

¹¹⁹ A.R.S. 46-701, 702, and 703.

1 telephone rates of eligible households.¹²⁰ Households with low income are also eligible
2 for financial assistance through federal programs such as Lifeline Assistance, which
3 provides discounts on basic monthly service, and Link-Up America, which assists
4 households with the costs of setting up phone service (wireless or wireline). Residents in
5 tribal communities may qualify for enhanced Lifeline assistance and expanded Link-Up
6 support, which provide additional discounts on monthly telephone service or set-up
7 costs.¹²¹

8 **Q: DR. ARON, CLEARLY SOME CONSUMERS WOULD BENEFIT FROM BEING**
9 **ALLOWED TO PAY BELOW-COST PRICES THAT ARE SUBSIDIZED WITH**
10 **UNIVERSAL SERVICE SUPPORT. ARE THERE DOWNSIDES TO THIS**
11 **SYSTEM IN ADDITION TO THE PURELY ECONOMIC NEGATIVE EFFECTS**
12 **ON OVERALL CONSUMER WELFARE AND COMPETITION THAT YOU**
13 **HAVE EXPLAINED?**

14 **A:** Yes. If some customers are allowed to pay below-cost prices, subsidized by universal
15 service funds, some other customers are providing the subsidy. For example, universal
16 service support tends to flow to high cost areas, which tend to be more rural areas. Urban
17 customers, then, tend to be net payers into the subsidy. There is no reason to believe that
18 such a system of cross subsidies is "fair" given that urban customers may well face
19 higher prices for housing, food, and other costs of living. Moreover, many urban

¹²⁰ Arizona Department of Economic Security, "Telephone Discount Programs," at <https://egov.azdes.gov/cmsinternet/intranet.aspx?id=2346&menu=34>.

¹²¹ See, FCC website, "Lifeline and Link-Up: Affordable Telephone Service," at <http://www.fcc.gov/cgb/consumerfacts/llu.html>; and "Tribal Initiative: Financial Assistance," at <http://www.fcc.gov/indians/financialassistance.html>.

1 customers (like many rural customers) live in households with low income, and there is
2 no obvious social policy objective being served by requiring these urban households to
3 subsidize rural households, including rural households with higher income levels. In
4 addition, increased universal service funding imposes a greater cost on Arizona
5 businesses, who would also shoulder part of the subsidy burden as telephone customers.
6 Imposing costs on businesses is detrimental to the business climate in Arizona, and
7 increases the prices paid by consumers for the goods and services produced by those
8 businesses.

9 **Q: ARE THERE NO "PURELY ECONOMIC"—I.E., EFFICIENCY—BENEFITS TO**
10 **UNIVERSAL SERVICE SUPPORT?**

11 **A:** There may be. The benefits of universal telephone subscription extend beyond the
12 benefit to the individual consumers whose prices are subsidized. When one additional
13 person attaches to the network, there is an externality effect because a potential benefit is
14 experienced by all customers on the network: they can call (or receive calls from) an
15 additional person. Whether this "network externality" is significant today is also an
16 empirical question, but at least as a matter of theory this effect can provide an economic
17 justification for encouraging network subscription even if it requires subsidy.

1 Q: WHAT IS THE ROLE OF "BENCHMARKS" IN THIS ANALYSIS?

2 A: The idea of benchmarks is the following. Suppose that access reform would reduce
3 access revenue for a given ILEC by \$5 per line per month (using hypothetical numbers
4 for purposes of exposition), and that the current retail price for basic local service were
5 \$15 per line per month. One means of recovering that \$5 in lost access revenue due to
6 access reform would be to increase the retail price of service by \$5 (to \$20). Another
7 would be to keep the retail price of service the same but provide a \$5 subsidy via a
8 universal service fund. The former would be the most efficient in the economic sense of
9 encouraging efficient competition, investment, and resource allocation, as I have
10 explained. The latter would be the least likely to cause a decline in wireline telephone
11 penetration, because there would still be the expected decrease in long distance prices
12 (due to the reduced access rates) but a much smaller increase in local service prices.¹²²
13 There is no free lunch, however. The larger is the draw from the universal service fund,
14 the greater is the economic inefficiency and cost to society caused by distorted
15 competition, distorted consumption decisions by consumer, and distorted incentives for
16 investment by providers; and the greater is the cost burden to the customers providing the
17 subsidy, as I have explained. Hence, it would generally be desirable to compensate the
18 carriers for reduced access revenues at least partly by increasing retail prices. One way

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1 to achieve this would be to identify a price level for retail service that would recover
2 some of the forgone access revenues at which customers would not be likely to defect
3 from the network in significant numbers (i.e., a reasonably "tolerable" or "affordable"
4 retail price level); and if that is not sufficient, to make up the rest of the access reduction
5 with universal service funds. For example, suppose that there was reason to believe that
6 if the price were to rise to \$18 (again using hypothetical numbers), this would cause
7 minimal decrease in subscribership due to the higher local price. Then the benchmark
8 could be set at \$18, which would permit recovery of \$3 of the \$5 of forgone access
9 revenues, and the remaining \$2 could be recovered from universal service funds. This
10 solution would likely be superior to a solution of recovering the entire decrease in access
11 revenues from universal service funds because it would at least partially rationalize the
12 retail price toward a more efficient level, it would impose less subsidy burden on the
13 customers supplying the subsidy, and it would go further toward diminishing the wide
14 range of retail rates across the state, bringing these rates closer together.¹²³ It would be
15 less efficient than a solution of fully recovering the forgone access revenues from retail

¹²² Even if the entire decrease in access revenues were covered by increased universal service support, that support would have to come from somewhere. Assuming it comes from the industry and not general tax revenues, there would generally be some increased cost to consumers to fund the universal service system.

¹²³ For example, Arizona Telephone Co.'s 1FR rate is \$9.25 per month, while Midvale Telephone Exchange's (Rio Verde) 1FR rate is over two and a half times higher, at \$24.46 per month. See ALECA Responses to Staff Discovery Request No. 1.3. Assuming the benchmark were set above the \$9.25 rate but below the \$24.46 rate, the benchmark would provide an opportunity for Arizona Telephone Co. to increase its rate without providing an opportunity for Midvale to do so, thereby bringing the two carriers' prices closer together. Dr. Oyefusi explains in his direct testimony how the benchmark is applied in scenarios such as this (see *Oyefusi Direct*).

1 prices, but may impose a lower potential risk to universal service goals (to the extent
2 there is any material risk).

3 Finally, a practical downside to adopting a benchmark rather than recovering all of the
4 forgone access revenues in the form of higher prices is that doing so would raise the
5 empirical challenge of identifying a "benchmark" price that minimizes the social burden
6 on the customers providing the subsidy, while not meaningfully impeding universal
7 service goals.

8 **Q: COULD YOU PLEASE SUMMARIZE YOUR CONCLUSIONS REGARDING**
9 **THE TRADEOFFS BETWEEN REVENUE RECOVERY VIA HIGHER RETAIL**
10 **PRICES, VERSUS DRAWS FROM A UNIVERSAL SERVICE FUND?**

11 **A:** Yes. Economics is clear in teaching us that allowing retail prices to rise to a level that at
12 least covers costs would generally advance overall consumer welfare by promoting an
13 efficient allocation of resources, promoting efficient investment in alternative
14 technologies, and promoting efficient competition. However, it is possible that such
15 prices would impede social universal service objectives by discouraging some consumers
16 from attaching to the telephone network at all. In such cases, there may be a conflict
17 between advancing overall consumer welfare and advancing universal service policy
18 objectives, and policy makers may choose to promote the latter at some expense of the
19 former by permitting prices to remain below cost and subsidizing the difference via
20 universal service funds. The facts in Arizona suggest that there are significant market

1 and regulatory safeguards to protect universal service goals so that overall telephone
2 penetration is likely to be resilient to price increases, however. Because universal service
3 mechanisms have a cost in the form of decreased overall social welfare and potentially
4 "unfair" burdens imposed on the subsidizing customers, before instituting a universal
5 service support mechanism to compensate for forgone access revenues policy makers
6 should therefore at a minimum consider whether increasing retail prices to recover the
7 access loss would in fact result in reduced telephone penetration, and (on the flip side)
8 consider whether universal service support would be likely to meaningfully increase
9 penetration.

10 **Q: BY ORDERING A REDUCTION IN INTRASTATE ACCESS CHARGES,**
11 **WOULD THE COMMISSION BE ABDICATING ANY REGULATORY**
12 **RESPONSIBILITY TO THE LOCAL EXCHANGE CARRIERS?**

13 **A:** No. On the contrary, the current system of support is crumbling as long distance minutes
14 fall, LEC lines decline, and the subsidy source erodes, as I have already described. It is
15 imperative both to provide a sustainable policy for wireline local exchange companies
16 that currently rely on access rates to support below-cost local exchange prices, and for
17 the ability of wireline long distance providers to compete on a more level playing field
18 with other technologies, to reduce the currently-excessive intrastate access rates in
19 Arizona. Of course, it would not be sustainable as a matter of economics nor advisable
20 as a matter of policy credibility for regulators to rescind the subsidies embedded in access

1 rates, but fail to alleviate regulatory restrictions that may have forced some local
2 exchange rates below cost. It would be most efficient to allow local exchange carriers
3 the opportunity to increase local exchange prices to recover the forgone access revenues,
4 but if the social policy objective of maintaining local exchange rates below cost is still
5 considered necessary, an explicit means to fund these prices, such as a universal service
6 fund, must be implemented.

7 **IX. Concluding Comments**

8 **Q: CAN YOU PLEASE SUMMARIZE THE BENEFITS TO CONSUMERS AND THE**
9 **ECONOMY FROM REFORMING INTRASTATE ACCESS RATES TO MIRROR**
10 **INTERSTATE RATES?**

11 **A:** Yes. Reforming the access regime by reducing intrastate access rates in Arizona as part
12 of a holistic regulatory approach that provides for offsetting revenues via retail rate relief
13 and/or universal service support can be expected to benefit consumers in the following
14 ways:

- 15 • Prices for wireline intrastate long distance services would be expected to fall, which
16 would directly benefit consumers and in turn would stimulate more usage of the
17 wireline long distance network and enhance opportunities for consumers to use the
18 technology that best suits their needs at the time;
- 19 • Distortions in the competitive process between wireline, broadband, and wireless
20 technologies would be reduced so that consumers could make decisions that reward
21 providers more closely for their relative efficiencies, service characteristics, and value
22

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1 in the eyes of customers, rather than on the basis of artificially high wireline long
2 distance services prices that distort consumer behavior;
3

- 4 • Investment incentives would be better aligned with the relative merits of different
5 service providers and technologies; and
6
7 • Wasteful arbitrage activities would be less attractive and would therefore likely be
8 reduced.
9

10 Q: **DOES THIS CONCLUDE YOUR DIRECT TESTIMONY?**

11 A: Yes, it does.

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EDUCATION

Ph.D., Economics, UNIVERSITY OF CHICAGO, Chicago, IL, 1985

A.B. (summa cum laude), Economics, UNIVERSITY OF CALIFORNIA AT LOS ANGELES, Los Angeles, CA, 1979

PRESENT POSITIONS

LECG, LLC Evanston, IL, 1995-present
Managing Director

Office Director, LECG Evanston

NORTHWESTERN UNIVERSITY, Communication Systems Strategy and Management Program, School of Communication, Evanston, IL, 2000 - present
Adjunct Associate Professor of Communication Studies

ACADEMIC AND PROFESSIONAL EXPERIENCE

NORTHWESTERN UNIVERSITY, J. L. Kellogg Graduate School of Management, Evanston, IL, 1985-1995
Visiting Assistant Professor of Managerial Economics, 1993-1995
Assistant Professor of Managerial Economics, 1985-1992

HOOVER INSTITUTION, 1992-1993
National Fellow

UNIVERSITY OF CHICAGO, Department of Economics, Chicago, IL, 1983-1984
Instructor

CIVIL AERONAUTICS BOARD, Office of Economic Analysis, Washington, DC,
Summers, 1979 and 1980
Staff Economist

HONORS & AWARDS

Guthman Research Chair, Kellogg Graduate School of Management, Northwestern University, Summer 1994.

Hoover National Fellowship, Hoover Institution, 1992-1993.

Faculty Research Fellow, National Bureau of Economic Research, 1987-1990.

Pepsico Research Chair, Northwestern University, 1990.

Kellogg Research Professorship, Northwestern University, 1989.

National Science Foundation Research Grant, 1987-1988.

Buchanan Chair, Kellogg Graduate School of Management, Northwestern University, 1987-1988.

IBM Chair, Kellogg Graduate School of Management, Northwestern University, 1986-1987.

RESEARCH INTERESTS

Industrial organization, antitrust economics, business strategy, pricing, information industries, network industries, telecommunications policy, theory of the firm, compensation and incentives.

TEACHING

Courses taught: Pricing Strategy; Information, Communication, and Competition (strategy and competition in communications industries); Intermediate Microeconomic Theory; Managerial Economics (microeconomic theory as applied to business strategy and decision making) at the M.B.A. level, The Economics of Information at the Ph.D. level.

Also qualified to teach: graduate Microeconomic Theory; Industrial Organization and Labor Economics; the Economics of Personnel; Public Finance; Applied Game Theory.

PUBLICATIONS AND WORKING PAPERS

"Investment in Next Generation Networks and Wholesale Telecommunications Regulation," with Robert W. Crandall, November 3, 2008,
<http://ssrn.com/abstract=1294910>.

- "Regulatory Policy and the Reverse Cellophane Fallacy," with David E. Burnstein, June 1 2008, <http://ssrn.com/abstract=1171292>, forthcoming, *Journal of Competition Law & Economics*.
- "Pricing Principles and Pricing Methodologies for Essential Facilities," May 2008.
- Contributing author, *ABA Section of Antitrust Law, Telecom Antitrust Handbook*, (2005), (Chicago: American Bar Association), 2005.
- "The Proper Treatment of Spare Network Capacity in Regulatory Cost Models," with Ana Danies, May 2005.
- "State Commissions Systematically Have Set UNE Prices Below Their Actual Costs," with Frank Pampush and E. Gerry Keith, 2004.
- "Broadband Adoption in the United States: An Empirical Analysis," with David E. Burnstein, in *Down to the Wire: Studies in the Diffusion and Regulation of Telecommunications Technologies*, Allan Shampine, ed., (Nova Science Publishers, Hauppauge, NY, 2003).
- "Developments in the Theory of Vertical Foreclosure as Applied to Regulated Telecommunications Markets" (March, 2002), Prepared for Presentation at The American Bar Association Section of Antitrust Law, 50th Annual Spring Meeting.
- "Modifications at HHIs for Vertical Supply Relationships" with Wenqing Li and James Langenfeld, White Paper submitted to European Commission, February 2000.
- "Economic Theories of Tying and Foreclosure Applied—And Not Applied—in *Microsoft*," with Steven S. Wildman, *Antitrust*, vol. 14, no. 1, 1999, pp.48-52.
- "Effecting a Price Squeeze Through Bundled Pricing," with Steven S. Wildman, in *Competition, Regulation, and Convergence: Current Trends in Telecommunications Policy Research*, Gillett and Vogelsang, eds. (New Jersey: Lawrence Erlbaum Associates, Inc.) 1999, pp. 1-17.
- "Worldwide Wait? How the Telecom Act's Unbundling Requirements Slow the Development of the Network Infrastructure," with Ken Dunmore and Frank Pampush, *Industrial and Corporate Change*, vol.7, no. 4, 1998, pp. 615-621.
- "The Pricing of Customer Access in Telecommunications," with Steven S. Wildman, *Industrial and Corporate Change*, vol. 5, no. 4, 1996, pp. 1029-1047.
- "Bonus and Penalty Schemes as Equilibrium Incentive Devices, With Application to Manufacturing Systems," with Pau Olivella, *Journal of Law, Economics, and Organization*, 10, Spring 1994, pp. 1-34.
- "Diversification as a Strategic Preemptive Weapon," *Journal of Economics and Management Strategy*, 2, Spring 1993, pp. 41-70.
- "Using the Capital Market as a Monitor: Corporate Spin-offs in an Agency Framework," *RAND Journal of Economics*, 22, Winter 1991, pp. 505-518.
- "Firm Organization and the Economic Approach to Personnel Management, *American Economic Review*, vol. 80, no. 2, May 1990, pp. 23-27.
- "The Introduction of New Products," with Edward P. Lazear, *American Economic Review*, vol. 80, no. 2, May 1990, pp. 421-426.

"Ability, Moral Hazard, Firm Size, and Diversification," *RAND Journal of Economics*, 19, Spring 1988, pp. 72-87.

"Worker Reputation and Productivity Incentives," *Journal of Labor Economics*, vol. 5, no. 4, October 1987, part 2, pp. S87-S106.

"The Role of Managerial Ability and Moral Hazard in the Determination of Firm Size, Growth and Diversification," Ph.D. Dissertation, University of Chicago, August 1985.

REPRESENTATIVE PRESENTATIONS

"Pricing Principles and Pricing Methodologies for Essential Facilities," The 36th Research Conference on Communication, Information and Internet Policy (TPRC), September 27, 2008.

"Regulatory Policy and the Reverse Cellophane Fallacy," with David E. Burnstein, 17th Biennial International Telecommunications Society Conference, Montréal, Québec, Canada, June 24-27, 2008.

"The Use of Economic Analysis in 'Industry Expert' Testimony," CLE course, XPRT Forum, March 7, 2008.

Presentations to the New Jersey Board of Public Utilities and to the New Jersey Legislature's Telecommunications Utilities Committee regarding the economic principles for a forward-looking regulatory agenda in light of the facts of competition nationwide and in New Jersey, and the costs of regulation, October – November 2006.

"The Interaction of Regulation with Economics and Financial Analysis in Litigation, Policy, and Strategy Consulting," CLE course, XPRT Forum, October 7, 2006.

"Comments on 'Economic Analysis in FCC Merger Proceedings,'" Conference on Economic Analysis and FCC Decisionmaking, presented by the Federal Communications Bar Association (FCBA) and Stanford Institute for Economic Policy Research (SIEPR), Washington D.C., March 15, 2006.

"Economic Principles for Consumer Protection Rules," Pri Telecom / Tech Briefing, Santa Clara, California, October 11, 2005.

"The Proper Treatment of Spare Network Capacity in Regulatory Cost Models," Presentation at the Advanced Workshop in Regulation and Competition, Center for Research in Regulated Industries, Skytop, Pennsylvania, May 2005.

"Telecommunications Regulation: What's Obsolete? What Will Become Obsolete?" Presentation at the State and City Telecom Reform Conference, Heartland Institute, Chicago, Illinois, December 2004.

"Trends in Telecommunications Demand & Supply," Presentation at the 46th Annual NARUC Regulatory Studies Program, Michigan State University, August 2004.

"The Economic Costs of Proposed Wireless Regulations in California," Presentation to Commissioners Brown and Kennedy, California Public Utilities Commission, San Francisco, California, April 2004.

"The Economics of UNE Pricing: Presentation to Staff," Ex parte presentation to the staff of the FCC, in FCC WC Docket No. 03-173: Review of the Commission's Rules Regarding the Pricing of Unbundled Network Elements and the Resale of Service by Incumbent Local Exchange Carriers, March 2004.

"The High Cost of Proposed New Wireless Regulations," Presentation to the Pacific Research Institute conference "Regulating Wireless in California: Bill of Rights... or Wrongs?," San Francisco, April 2003.

"The TELRIC Showdown," Panelist, NARUC Staff Subcommittee on Telecommunications, 2002 Annual Convention, Chicago, Illinois, November 2002.

"Economic Principles for Efficient Pricing of Municipal Rights-of-Way," National Association of Telecommunications Officers and Advisors (NATOA), Chicago, Illinois, September 2002.

"Trends in Voice and Broadband Competition in Telecommunications Markets: Markets, Strategies, and Regulation," 82nd Annual Convention of the Indiana Telecommunications Association, Lexington, Kentucky, June 2002.

"Broadband Deployment in the United States," Emerging Opportunities in Broadband Symposium, Northwestern University, Evanston, Illinois, December 2001.

"Local Competition in Illinois," Illinois Telecommunications Symposium, Northwestern University, Evanston, Illinois, December 2000.

"Licensing and Access to Innovations in Telecommunications and Information Services," Telecommunications Policy Research Conference, Alexandria, Virginia, September 2000.

"Effecting a Price Squeeze Through Bundled Pricing," Federal Communications Commission, Washington, D.C., May 1999.

"Competitive and Strategic Use of Optional Calling Plans and Volume Pricing Plans," The Institute for International Research Conference for Competitive Pricing of Telecommunications Services, Chicago, Illinois, July 1998.

"Effecting a Price Squeeze Through Bundled Pricing," Consortium for Research in Telecommunications Policy Conference, University of Michigan, Ann Arbor, Michigan, June 1998.

"The Pricing of Customer Access in Telecommunications," Conference on Public Policy and Corporate Strategy for the Information Economy, Evanston, Illinois, May 1996.

"Diversification as a Strategic Preemptive Weapon," University of Iowa, Iowa City, Iowa, February 1994.

"Diversification as a Strategic Preemptive Weapon," University of Buffalo, Buffalo, New York, February 1994.

"Diversification as a Strategic Preemptive Weapon," University of Southern California, Los Angeles, California, December 1993.

"Strategic Pricing," Winter Meetings of the Econometric Society, Discussant, Anaheim, California, December 1993.

"Innovation, Imitation, Productive Differentiation, and the Value of Information in New Markets," Michigan State University, Lansing, Michigan, November 1993.

"Diversification as a Strategic Preemptive Weapon," Rutgers University, New Brunswick, New Jersey, November 1993.

"Diversification as a Strategic Preemptive Weapon," University of California at Santa Cruz, Santa Cruz, California, November 1993.

"Diversification as a Strategic Preemptive Weapon," Graduate School of Business, Stanford University, Stanford, California, November 1993.

"Innovation, Imitation, Productive Differentiation, and the Value of Information in New Markets," Purdue University, West Lafayette, Indiana, September 1993.

"Innovation, Imitation, Productive Differentiation, and the Value of Information in New Markets," Summer Meetings of the Econometric Society, Boston University, Boston, Massachusetts, June 1993.

"Innovation, Imitation, Productive Differentiation, and the Value of Information in New Markets," University of California, Department of Economics, Berkeley, California, May 1993.

"Innovation, Imitation, Productive Differentiation, and the Value of Information in New Markets," Stanford University, Graduate School of Business, Stanford, California, May 1993.

"Diversification as a Strategic Preemptive Weapon," Stanford University, Graduate School of Business, Stanford, California, April 1993.

"Innovation, Imitation, Productive Differentiation, and the Value of Information in New Markets," Hoover Institution, Stanford, California, April 1993.

"Innovation, Imitation, Productive Differentiation, and the Value of Information in New Markets," University of California, Graduate School of Business, Berkeley, California, February 1993.

"Innovation, Imitation, Productive Differentiation, and the Value of Information in New Markets," Stanford University, Department of Economics, Stanford, California, February 1993.

"Innovation, Imitation, Productive Differentiation, and the Value of Information in New Markets," Hoover Institution, Stanford, California, January 1993.

"Pricing Strategies," Session Discussant, 1992 North American Winter Meeting of The Econometric Society, Anaheim, California, January 1992.

"Diversification as a Strategic Preemptive Weapon," University of Toronto, Toronto, Canada, November 1991.

"Diversification as a Strategic Preemptive Weapon," Queen's University, Kingston, Ontario, Canada, November 1991.

"Bonuses and Penalties as Equilibrium Incentive Devices, with Application to Manufacturing Systems," University of Chicago, Chicago, Illinois, June 1991.

"The Timing of Entry into New Markets," Summer Meetings of the Econometric Society, University of Pennsylvania, Philadelphia, Pennsylvania, June 1991.

"Innovation, Imitation, Productive Differentiation, and the Value of Information in New Markets," University of Chicago, Chicago, Illinois, April 1991.

"Bonuses and Penalties as Equilibrium Incentive Devices, with Application to Manufacturing Systems," Winter Meetings of the Econometric Society, Washington, D.C., December 1990.

"Corporate Spin-offs in an Agency Framework," University of Washington, Seattle, Washington, October 1990.

"The Timing of Entry Into New Markets," University of British Columbia, Vancouver, British Columbia, October 1990.

"Corporate Spin-offs in an Agency Framework," Texas A&M University, College Station, Texas, April 1990.

"Firm Organization and the Economic Approach to Personnel Management," Winter Meetings of the American Economic Association, New York, New York, December 1989.

"Corporate Spin-offs in an Agency Framework," Western Finance Association Meetings, Seattle, Washington, June 1989.

"Corporate Spin-offs in an Agency Framework," University of Rochester, Rochester, New York, May 1989.

"Corporate Spin-offs in an Agency Framework," North American Summer Meetings of the Econometric Society, Minneapolis, Minnesota, June 1988.

"Competition, Relativism, and Market Choice," North American Summer Meetings of the Econometric Society, Berkeley, California, June 1987.

"Competition, Relativism, and Market Choice," University of Chicago, Chicago, Illinois, April 1987.

"Rate Reform and Competition in Electric Power," Discussant, Conference on Competitive Issues in Electric Power, Northwestern University, Evanston, Illinois, March 1987.

"Worker Reputation and Productivity Incentives," New Economics of Personnel Conference, Arizona State University, Tempe, Arizona, April 1986.

"Ability, Moral Hazard, and Firm Diversification," Various Universities, 1985, 1994, including Yale University, University of Rochester, Stanford University, University of Minnesota, California Institute of Technology, Duke University, Northwestern University,

Brown University, Harvard University, University of California - Los Angeles, University of Pennsylvania.

ACADEMIC JOURNAL REFEREEING

Dr. Aron has served as a referee for *The Rand Journal of Economics*, *the Journal of Political Economy*, *the Journal of Finance*, *the American Economic Review*, *the Quarterly Journal of Economics*, *the Journal of Industrial Economics*, *the Journal of Economics and Business*, *the Journal of Economic Theory*, *the Journal of Labor Economics*, *the Review of Industrial Organization*, *the European Economic Review*, *the Journal of Economics and Management Strategy*, *the International Review of Economics and Business*, *the Quarterly Review of Economics and Business*, *Management Science*, *the Journal of Public Economics*, *the Journal of Institutional and Theoretical Economics*, and the National Science Foundation.

SELECTED TESTIMONY AND OTHER ENGAGEMENTS

Deposition testimony on damages in a matter before the United States District Court, Western District of Texas, Austin Division, regarding intercarrier "access fees" for exchange of Internet Protocol telecommunications traffic, October 2009.

Expert testimony before the New Jersey Board of Public Utilities regarding intrastate switched access charges and retail rate rebalancing, September 2009.

Expert testimony before the Circuit Court for the Third Judicial Circuit, Madison County, Illinois in class action matter pertaining to allegations that a statutory refund required of defendant telephone company was improperly distributed, October 2009.

Advice and presentation to executives of a large Israeli telecommunications company regarding the Israeli regulatory regime, unbundling obligations, pricing, costing, and competitive reform, February 2009.

Deposition testimony in a matter before the Delaware Circuit Court regarding a contractual dispute between wireless telecommunications companies, on the issue of irreparable harm pertaining to alleged violation of exclusive territory provisions, November 2008.

Written expert evidence before the Canadian Radio-television and Telecommunications Commission in the matter of an application to expand the unbundling obligations of the ILECs for the provision of certain broadband services; regarding the effects of the requested unbundling obligations on competition, investment, and social welfare in Canada, July 2008.

Deposition and jury trial testimony in a matter before the Superior Court of the State of California, County of Los Angeles on the telecommunications business environment and viability of particular telecommunications business models in the late 1990s/early 2000s in

a matter regarding an alleged breach of contract in the mobile satellite services industry, April/July 2008.

Written expert declarations before the California Public Utilities Commission in the matter of a rulemaking regarding whether to adopt, amend, or repeal regulations governing the retirement by incumbent local exchange carriers of copper loops and related facilities used to provide telecommunications services; regarding the effects of copper retirement regulation on investment incentives for next generation networks, January 2008.

Analysis of US and global subsea telecommunications fiber capacity investments and swap arrangements during the late 1990s and early 2000s, in a litigation matter alleging failure of defendant to disclose material information to plaintiffs (case settled before expert disclosure), 2008.

Written testimony before the Public Utility Commission of Texas regarding the regulatory philosophy of universal service policy, and competitive implications of proposed universal service distribution mechanisms, November 2007.

Expert evidence before the Canadian Radio-television and Telecommunications Commission regarding the economically appropriate methodology for pricing wholesale telecommunications services and essential facilities, October 2007.

Expert testimony before the Indiana Utility Regulatory Commission regarding the competitive effects on a new entrant in the video services marketplace of disclosure of highly detailed deployment data, August 2007.

Deposition testimony in a matter before the Oklahoma Court of Tax Review regarding the market factors affecting valuation of telecommunications assets during the relevant tax year of the dispute, June 2007.

Written evidence before the Canadian Radio-television and Telecommunications Commission regarding the proper economic principles that should govern determination of regulatory costs, and the effects of regulatory cost determination on economic efficiency and competition, May 2007.

Expert testimony before the New Jersey Board of Public Utilities regarding its review of telecommunications regulations and proposal to establish new regulations on incumbent and competitive wireline carriers, March 2007.

Analysis of competitive effects and effects on consumer welfare of deployment of IP video services in competition with incumbent video services providers, 2007.

Damages analysis as consulting expert in an international arbitration matter regarding disputed availability of and access to subsea and terrestrial telecommunications fiber capacity from mid 1990s through mid 2000s, with focus in Asia and Europe, 2007.

Expert testimony before the Michigan Public Service Commission regarding the competitive effects of total service resale of telecommunications services, and restrictions on resale pertaining to aggregation of demand for volume discounts, November 2006.

Preliminary Expert Report of Debra J. Aron, "The U.S. Long-haul Fiber Optic Network Industry: 1996-2001," in a matter in the Superior Court of the state of California involving disputed investment in long haul capacity in the U.S., June, 2006.

Expert testimony before the Kentucky Public Service Commission, Tennessee Regulatory Authority, and Mississippi Public Service Commission regarding the competitive effects of the proposed AT&T acquisition of BellSouth, June 2006.

Deposition testimony in a matter before the Oklahoma Court of Tax Review regarding the status of competition for wireline local exchange telephone service in Oklahoma and the likely economic effect of such competition on the forward looking value of company assets, March 2006.

Expert testimony before the California Public Utilities Commission regarding the competitive landscape in California and the desirability of establishing a Uniform Regulatory Framework for the telecommunications industry in the state of California, February 2006.

Deposition testimony and trial testimony in the Court of Chancery in the state of Delaware In and For New Castle County and in Circuit Court of Cook County, Illinois County Department, Chancery Division, regarding the possibility of "irreparable harm" to Sprint Nextel's wireless affiliates in connection with Sprint's acquisition of Nextel Corporation, November 2005 – July 2006.

Expert testimony before the California Public Utilities Commission and the Public Utilities Commission of Ohio evaluating the economic benefits and competitive impacts of the proposed acquisition of AT&T by SBC, June–August 2005.

Expert testimony before the Oklahoma Corporation Commission regarding the proper economic principles for reduced regulation of retail telecommunications services and regarding the determination of the amount of a supersedeas bond to quantify the economic harm likely to result from the award of a stay of Commission order that would grant pricing flexibility and require broadband investment, June – August 2005.

Expert testimony before the Kansas Corporation Commission regarding the sustainability of competition in communications markets in Kansas, June 2005.

Cost and economic analysis for a large telecommunications firm regarding tariffed volume and term-discounted pricing plans for special access services based on regulatory requirements for consistency of prices with cost structure, March 2005.

Expert testimony before the Missouri Public Service Commission evaluating the potential competitive reclassification of local telephone service in Missouri, January 2005.

Expert testimony before the Public Utilities Commission of Ohio and the Public Service Commission of Wisconsin regarding the effects of UNE pricing on the competitive telecommunications markets, July 2004.

Expert testimony before the Florida Public Service Commission and the Georgia Public Service Commission, written expert testimony before the public utilities commissions in Mississippi, Alabama, North Carolina, South Carolina, Tennessee, and Kentucky, and

deposition testimony, regarding the proper principles for determining which network elements should be provided to competitors on an unbundled basis at regulated rates; including testimony in support of a business case model of the viability of efficient competitive entry in specific geographic markets in each aforementioned state, January-March 2004.

Ex parte presentation "The Economics of UNE Pricing," to the Federal Communications Commission staff, with William Rogerson, March 2004.

White Papers, "The Economics of UNE Pricing," December 2003, and "A Further Analysis of the Economics of UNE Pricing," January 2004, with William Rogerson, submitted to the Federal Communications Commission in FCC WC Docket No. 03-173: Review of the Commission's Rules Regarding the Pricing of Unbundled Network Elements and the Resale of Service by Incumbent Local Exchange Carriers.

White Paper, "The Effects Of Below-Cost TELRIC-Based UNE Prices On CLEC And ILEC Investment," submitted to the Federal Communications Commission in FCC WC Docket No. 03-173: Review of the Commission's Rules Regarding the Pricing of Unbundled Network Elements and the Resale of Service by Incumbent Local Exchange Carriers, January 2004.

Expert testimony before the Illinois Commerce Commission regarding the proper determination of Total Element Long Run Incremental Cost (TELRIC) for establishing prices for network elements, March 2004.

Expert testimony before the Illinois General Assembly regarding the effects of current regulated UNE pricing of telecommunications elements on competitive telecommunications markets in Illinois, May 2003.

Expert testimony before the Public Utilities Commission of Ohio on issues related to rights-of-way fees charged to electric, water, and telecommunications companies in the City of Toledo, Ohio, March 2003.

Reports evaluating the cost impacts and public policy implications of the proposed California Consumer Protection rules on wireless carriers and customers, February 2003 and September 2003.

Expert testimony before the state regulatory commissions in Ohio, Illinois, Indiana, and Kansas on the economic principles for evaluating anticompetitive claims regarding "winback" pricing by incumbent telecommunications carriers, 2002 - 2003.

Report pertaining to the economic and antitrust analysis of price squeezes, and the suitability of imputation rules as a protection against an anticompetitive price squeeze, for a carrier in a foreign market, 2002.

Expert testimony before the Michigan Public Service Commission pertaining to allegations of anticompetitive effects of long term contracts, 2002.

For a small manufacturer of telecommunications equipment, consulting support to evaluate the antitrust implications of a proposed acquisition, 2002.

White Paper submitted to the Texas Public Service Commission pertaining to the competitive effects of "winback" and "retention" pricing, 2002.

In Order Instituting Rulemaking on the Commission's Own Motion to Assess and Revise the new Regulatory Framework for Pacific Bell and Verizon California Incorporated, written declaration submitted to the California Public Utilities Commission pertaining to the economic incentives created by modifications to the State's alternative regulation plan and competitive reclassification of services, 2002.

Statement to the Federal Communications Commission regarding the potential economic causes of sustained price increases for cable television services, 2002.

Expert testimony before the Kansas Corporation Commission regarding the antitrust principles relevant to establishing rules for competitive reclassification of services under governing state law, 2002.

For a national wireless telecommunications carrier, consulting support pertaining to litigation regarding access charges, 2001.

Expert testimony before the Missouri Public Service Commission pertaining to price squeeze allegations in the long-distance market, 2001.

Expert affidavit submitted to the Circuit Court in the state of Wisconsin, pertaining to irreparable harm caused if court declined to grant a stay of disputed performance remedy plan, 2001.

Expert testimony before the public utilities commissions of Illinois, Ohio, California, and Indiana, pertaining to the economic viability of constructing and provisioning ADSL services, including market definition and examination of competitive conditions, 2001.

Expert testimony before the Illinois Commerce Commission pertaining to the proper economic principles governing unbundling obligations, 2001.

In the matter of H & R Mason Contractor's et al. v. Motorola, Inc. et al., before the Circuit Court of Cook County, Illinois, expert affidavit examining the economic impediments to class certification, focusing on the determinants of price in the relevant equipment markets, April 2001.

For a competitive local exchange provider in a foreign market, consulting support regarding the proper determination of avoided costs for resale of incumbent services, April 2001.

For a major Japanese telecommunications equipment manufacturer, evaluated the revenue potential and desirability of entering several advanced services equipment markets worldwide, for the purposes of assisting the client to evaluate a proposed acquisition, February 2001.

Expert testimony in the Illinois Commerce Commission's Investigation Into Certain Payphone Issues, examined the economic and public policy issues pertaining to pricing of access lines for independent pay telephone providers, April 2001.

In the matter of the Illinois Public Utility Commission's Investigation Into Tariff Providing Unbundled Local Switching And Shared Transport, expert testimony regarding economic antitrust perspectives on obligations of firms to affirmatively help their competitors, and related public policy issues, April 2001.

In response to Request for Consultations by the U.S. Trade Representative (USTR) with the Government of Mexico before the World Trade Organization (WTO) regarding barriers to competition in Mexico's telecommunications market, analyzed regulated switched access rates in the U.S. in comparison with those charged by Telmex, November 2000.

Declaration submitted to the Texas Public Utility Commission, analyzed proposed regulation aimed at preventing incumbents from executing a price squeeze; developed a framework for evaluating claims of a price squeeze consistent with antitrust principles of predation, August 2000.

For a taxicab company, analysis of regulatory requirements in the City of Chicago pertaining to valuation of medallions and valuation of capital for purposes of regulatory ratemaking proceeding, 2000.

Written and oral testimony before the public utility commissions of Illinois and Michigan in various arbitration matters pertaining to the proper compensation for the use by competitors of client's facilities for foreign exchange services, 2000.

For a firm in the aluminum fabrication industry, in the matter of a potential merger between vertically integrated competitors, developed a methodology for adjusting the HHI measure of market concentration to account for the vertical control by the merging parties of downstream competitors, 2000.

For a large newspaper publisher, in the possible acquisition of the San Francisco Chronicle, analyzed the potential antitrust impediments to an acquisition by the client of the Chronicle, including issues of geographic and product market definition, the interplay between advertising markets and customer markets, and the relevant implications of the Newspaper Preservation Act, 1999.

Testimony before the Illinois Commerce Commission regarding the proper economic interpretation of the standards for declaring a service competitive under the Illinois Public Utilities Act, and quantification of the extent of competition in relevant Illinois markets, including discussion of market definition; the relevance of entry conditions; the relevance of resale competition and analysis of various resale entry strategies; the interdependence of resale and facilities-based entry strategies; and implementation of a technology-based method of measuring market participation, 1999-2000.

For a firm in the consumer mapmaking business, analyzed market definition, concentration, and efficiencies from a proposed merger, 1999.

Affidavit submitted jointly with Robert G. Harris to the Federal Communications Commission in the matter of "unbundled network elements" and commenting on the proper interpretation of the "Necessary and Impair" standard, including discussion of entry conditions and the business-case approach to valuation of an entry strategy, April 1999; reply affidavit May 1999.

Affidavit, "An Analysis of Market Power in the Provision of High-Capacity Access in the Chicago LATA," submitted to the Federal Communications Commission, including an analysis of the US DOJ merger guidelines and their applicability to regulatory relief in a regulated market, as well as extensive empirical modeling of the costs and business case for network buildout of high capacity facilities, February 1999.

White Paper, "Proper Recovery of Incremental Signaling System 7 (SS7) Costs for Local Number Portability," submitted to the Federal Communications Commission, April 1999.

PROFESSIONAL ORGANIZATIONS

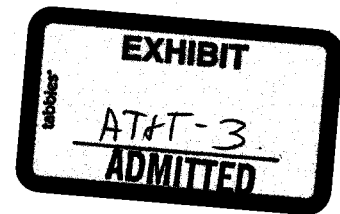
Member, American Economic Association

Member, Econometric Society

Associate Member, American Bar Association

Past Member, Telecommunications Policy Research Conference Program Committee

November 2009



BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS

KRISTIN K. MAYES - Chairman
GARY PIERCE
PAUL NEWMAN
SANDRA D. KENNEDY
BOB STUMP

IN THE MATTER OF THE REVIEW AND
POSSIBLE REVISION OF ARIZONA UNIVERSAL
SERVICE FUND RULES, ARTICLE 12 OF THE
ARIZONA ADMINISTRATIVE CODE.

Docket No. RT-00000H-97-0137

IN THE MATTER OF THE INVESTIGATION OF
THE COST OF TELECOMMUNICATIONS
ACCESS.

Docket No. T-00000D-00-0672

REPLY TESTIMONY OF

DR. DEBRA J. ARON

On Behalf of

AT&T Communications of the Mountain States, Inc. and TCG Phoenix

February 5, 2010

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DOCKET No. RT-00000H-97-0137
DOCKET No. T-00000D-00-0672
AT&T COMMUNICATIONS OF THE MOUNTAIN STATES, INC.
AND TCG PHOENIX
REPLY TESTIMONY OF DR. DEBRA J. ARON

I. Introduction

Q: ARE YOU THE SAME DR. DEBRA J. ARON WHO SUBMITTED DIRECT TESTIMONY IN THIS PROCEEDING?¹

A: Yes, I am.

Q: WHAT IS THE PURPOSE OF YOUR REPLY TESTIMONY?

A: I am responding to the Direct Testimony of Mr. Douglas Denney filed on behalf of Eschelon Telecom of Arizona, Mountain Telecommunications, Electric Lightwave, McLeodUSA Telecommunications Services, tw telecom of Arizona, and XO Communications Services (hereafter referred to collectively as "Joint CLECs"); the Direct Testimony of Douglas Garrett on behalf of Cox Arizona Telcom; the Direct Testimony of Douglas Duncan Meredith on behalf of the Arizona Local Exchange Carriers Association ("ALECA"); the Direct Testimony of Lisa Hensley Eckert on behalf

¹ Direct Testimony of Dr. Debra J. Aron on Behalf of AT&T Communications of the Mountain States, Inc. and TCG Phoenix, *In the Matter of the Review and Possible Revision of Arizona Universal Service Fund Rules, Article 12 of the Arizona Administrative Code and In the Matter of the Investigation of the Cost of Telecommunications Access*, Before the Arizona Corporation Commission, Docket Nos. RT-00000H-97-0137 and T-00000D-00-0672, (hereafter *Aron Direct Testimony*), December 1, 2009.

1 of Qwest Corporation and Qwest Communications Company (hereafter referred to as
2 "Qwest"); the Direct Testimony of Don Price filed on behalf of Verizon California,
3 Verizon Business Services, and Verizon Long Distance (hereafter referred to as
4 "Verizon"); the Direct Testimony of Dr. Ben Johnson on behalf of the Residential Utility
5 Consumer Office (hereafter referred to as "RUCO"); and the Direct Testimony of Wilfred
6 Shand on Behalf of Staff of the Arizona Corporation Commission (hereafter referred to as
7 "Staff").²

² Direct Testimony of Douglas Denney on Behalf of Eschelon Telecom of Arizona, Inc.; Mountain Telecommunications, Inc.; Electric Lightwave, LLC; McLeodUSA Telecommunications Services, Inc. d/b/a PAETEC Business Services; tw telecom of Arizona LLC; and XO Communications Services, Inc., *In the Matter of the Review and Possible Revision of Arizona Universal Service Fund Rules, Article 12 of the Arizona Administrative Code and In the Matter of the Investigation of the Cost of Telecommunications Access*, Before the Arizona Corporation Commission, Docket Nos. RT-00000H-97-0137 and T-00000D-00-0672, (hereafter *Denney Direct Testimony*), December 1, 2009; Direct Testimony of Douglas Garrett on Behalf of Cox Arizona Telcom, L.L.C., *In the Matter of the Review and Possible Revision of Arizona Universal Service Fund Rules, Article 12 of the Arizona Administrative Code and In the Matter of the Investigation of the Cost of Telecommunications Access*, Before the Arizona Corporation Commission, Docket Nos. RT-00000H-97-0137 and T-00000D-00-0672, (hereafter *Garrett Direct Testimony*), December 1, 2009; Testimony of Douglas Duncan Meredith on Behalf of the Arizona Local Exchange Carriers Association, *In the Matter of the Review and Possible Revision of Arizona Universal Service Fund Rules, Article 12 of the Arizona Administrative Code and In the Matter of the Investigation of the Cost of Telecommunications Access*, Before the Arizona Corporation Commission, Docket Nos. RT-00000H-97-0137 and T-00000D-00-0672, (hereafter *Meredith Direct Testimony*), December 1, 2009; Direct Testimony of Lisa Hensley Eckert on Behalf of Qwest Corporation and Qwest Communications Company, LLC, *In the Matter of the Review and Possible Revision of Arizona Universal Service Fund Rules, Article 12 of the Arizona Administrative Code and In the Matter of the Investigation of the Cost of Telecommunications Access*, Before the Arizona Corporation Commission, Docket Nos. RT-00000H-97-0137 and T-00000D-00-0672, (hereafter *Eckert Direct Testimony*), December 1, 2009; Direct Testimony of Don Price on Behalf of Verizon, *In the Matter of the Review and Possible Revision of Arizona Universal Service Fund Rules, Article 12 of the Arizona Administrative Code and In the Matter of the Investigation of the Cost of Telecommunications Access*, Before the Arizona Corporation Commission, Docket Nos. RT-00000H-97-0137 and T-00000D-00-0672, (hereafter *Price Direct Testimony*), December 1, 2009; Testimony of Ben Johnson, Ph.D. on Behalf of the State of Arizona Residential Utility Consumer Office, *In the Matter of the Review and Possible Revision of Arizona Universal Service Fund Rules, Article 12 of the Arizona*

1
2 **Q. DO YOU HAVE ANY COMMENTS ABOUT THE DIRECT TESTIMONY**
3 **OVERALL IN THIS CASE?**

4 A. Yes. In the Telecommunications Act of 1996 ("TA96"), Congress established a new
5 paradigm for the communications industry in which markets were opened so as to bring
6 the benefits of competition to consumers. As part of that new paradigm, implicit
7 subsidies were to be eliminated or replaced with explicit subsidies.³ Congress recognized
8 that for competition to function effectively and enhance economic efficiency and
9 consumer welfare, the old system of cross-subsidies from some providers to other
10 providers could not and should not be perpetuated.

11 Now, over 14 years since the passage of TA96, the communications industry has in fact
12 undergone a sea-change as competition has developed in ways perhaps not even imagined
13 in 1996. Competition is fundamentally intermodal, technological innovation has

Administrative Code and In the Matter of the Investigation of the Cost of Telecommunications Access, Before the Arizona Corporation Commission, Docket Nos. RT-00000H-97-0137 and T-00000D-00-0672, (hereafter *Johnson Direct Testimony*), January 6, 2010; Direct Testimony of Wilfred Shand, Public Utilities Analyst Manager, Utilities Division, Arizona Corporation Commission, *In the Matter of the Review and Possible Revision of Arizona Universal Service Fund Rules, Article 12 of the Arizona Administrative Code and In the Matter of the Investigation of the Cost of Telecommunications Access*, Before the Arizona Corporation Commission, Docket Nos. RT-00000H-97-0137 and T-00000D-00-0672, (hereafter *Shand Direct Testimony*), January 8, 2010.

³ Telecommunications Act of 1996, § 254(e). See also, Order on Remand and Report and Order and Further Notice of Proposed Rulemaking, *In the Matter of High-Cost Universal Service Support and Federal-State Joint Board on Universal Service et al.*, Before the Federal Communications Commission, WC Docket No. 05-337 and CC Docket 96-45 et al., FCC 08-262, (released November 5, 2008), (hereafter *2008 NPRM*), Appendix A, ¶ 169.

1 broadened our concepts of communications, and every-day communications vastly
2 transcend traditional concepts of voice telephony.

3 Remaining among the last vestiges of the pre-1996 marketplace, however, are the very
4 stubborn remnants of the legacy access system, which favors some technologies over
5 other technologies, and forces some consumers to subsidize other consumers not on the
6 basis of need or equity, but on the basis of which technology they choose for their
7 communications needs.

8 This proceeding is about effecting long-overdue policy change in Arizona to harmonize
9 intrastate access policy with the goals of the Telecommunications Act and with the
10 realities of technological change and competition, by taking a measured step toward
11 relieving Arizona consumers and the Arizona communications marketplace from the
12 harmful impact of inflated intrastate switched access charges. The decision the
13 Commission makes in this proceeding will affect all communications providers in
14 Arizona, whether they are participating in this proceeding or not. Rather than protect the
15 interests of any carriers in this proceeding or seek to balance the interests of any of the
16 parties, I encourage the Commission to look beyond the carriers' interests to the
17 objectives and directives of the Telecommunications Act and to the overriding goals of
18 consumer welfare and economic efficiency. The current system of distorted access rates

1 is unstable, inefficient, harmful to competition, harmful to efficiency, and, therefore,
2 harmful to consumers. Indeed, at this point, it is even harmful to the carriers that it was
3 originally intended to support.

4 The arguments made by the CLECs to protect their current immunity from access rate
5 reductions and by Qwest to protect its excessive intrastate access rates in Arizona are
6 simply unavailing or incorrect. All LECs have market power with respect to switched
7 access service. It is proper public policy to regulate those prices, and a reasonable level at
8 which to regulate them is the one that has been in effect for nearly a decade in the
9 interstate jurisdiction for the same carriers for the same functionality as intrastate access.
10 Any higher level is simply a monopoly markup imposed by local exchange companies on
11 long distance carriers and their customers.

12 ALECA's arguments, although largely correct in principle, are made in support of a
13 proposal that is inadequate to address the problems it articulates, or to achieve the goals it
14 identifies. Indeed ALECA is well aware that its proposal would not address significant
15 arbitrage issues, because it explained as much in its white paper and discovery responses
16 issued before the direct testimony. Staff similarly articulates the right principles but seeks
17 to address them with an inadequate solution.

1 Access reform requires regulatory conviction, because it requires regulators to confront
2 the magnitude of the implicit subsidies that have been embedded in the current intrastate
3 access rates and find an explicit source of revenues to replace them, either through retail
4 rate increases or universal service support. The fact that the amount of implicit subsidies
5 embedded in current intrastate access rates is (according to ALECA) material in Arizona
6 is not a justification for shying away from attacking the problem in earnest, however. On
7 the contrary, the greater the amount of implicit subsidy in a system, the more harmful it is
8 to efficiency and competition, and the more urgent it is that it be corrected. I encourage
9 this Commission to engage the issues in this proceeding by looking beyond the rhetoric
10 and embracing the facts and analysis. They lead to the conclusion that meaningful,
11 comprehensive access reform that reduces the rates of all ILECs to their interstate levels,
12 and caps all CLECs' rates at the ILECs' levels, is a reasonable step toward long-overdue
13 compliance with the directives and goals of TA96; is consistent with sound public policy
14 and economic principles; can be achieved without undue rate shock to consumers; is in
15 the public interest; and, indeed, is necessary.

1 **II. Response to the Direct Testimony of Mr. Douglas Denney on Behalf of Joint CLECs**

2 **Q: DO YOU HAVE ANY GENERAL OBSERVATIONS ABOUT THE JOINT**
3 **CLECS' TESTIMONY?**

4 **A:** Yes. The Joint CLECs currently are the recipients of a monopoly markup imposed on
5 IXC's (and IXC's' customers) via the CLECs' excessive intrastate access rates, which are
6 protected by the imprimatur of the regulator, and sustained by their market power over
7 switched access to their customers. Reducing this markup would impose a greater
8 requirement for each CLEC to earn its revenues from its own customers by competing
9 effectively in the marketplace—a prospect that is decidedly less attractive and more
10 burdensome to CLECs than being allowed to continue collecting a monopoly stream of
11 income. The accusatory and inflammatory tone of the Joint CLECs' testimony is not
12 surprising when viewed in that context, but the content of their testimony cannot gain
13 validity by virtue of the invective with which it is stated. In fact, I will explain that the
14 joint CLECs' arguments are factually incorrect, economically incorrect, irrelevant, and/or
15 entirely unsupported, and in some cases have long been discredited. Specifically,

- 16 • The Joint CLECs' accusations of hypocrisy by AT&T are backward—in fact, unlike
17 the joint CLECs and other parties in this proceeding, AT&T is proposing to take the
18 same medicine it has prescribed for others. AT&T's proposal is to reduce all LEC
19 access rates to interstate rates, including its own.
- 20 • The Joint CLECs' claim that regulating their access rates would be “radical” and
21 counter to recent trends tending toward less regulation is unfounded. The purpose of
22 access reform is to unwind the effects of legacy regulation and reduce regulatory

1 burdens on consumers and competition so that competition can function most
2 effectively in retail markets. To this end, CLECs' rates for the identical functionality
3 as intrastate switched access have been regulated for years in the federal (interstate
4 switched access) and state (local call termination) arenas and, in the last decade, more
5 and more states are regulating intrastate switched access as well. CLECs' interstate
6 access rates, which are rates for the same functionality as intrastate access, have been
7 capped at ILECs' rates by the FCC since 2001, and AT&T proposes only to cap
8 CLECs' intrastate rates at the same level. CLECs' reciprocal compensation rates for
9 local call termination, which is also the same functionality as interstate and intrastate
10 switched access, are regulated by the Arizona Commission, at far lower rates still.

- 11 • The Joint CLECs' claim that the conditions that led the FCC to cap CLEC access
12 rates in 2001 no longer apply is incorrect. The FCC recognized that CLECs have
13 market power with respect to switched access service. They still have that market
14 power, notwithstanding the competitive nature of the retail local exchange
15 marketplace, because no amount of competition in the retail market renders switched
16 access a competitive service. The fact that CLECs' intrastate access rates exceed
17 those of the ILECs is evidence of that market power. The FCC has reiterated its
18 conclusions since its initial decision capping CLEC rates and each order or proposed
19 order since that time incorporates caps on CLEC rates that are equal to or lower than
20 the current caps.
- 21 • The Joint CLECs' cries of poverty vis à vis the other carriers in this proceeding are
22 unavailing, particularly in light of the fact that the amount of access revenues that
23 would be forgone to the CLECs due to AT&T's proposed access reform in Arizona
24 would constitute less than one tenth of one percent of their total annual revenues from
25 their global operations, according to their own revenue figures provided in their
26 testimony.
- 27 • The Joint CLECs' comments regarding special access margins are entirely irrelevant
28 to this proceeding, which is not about intrastate special access rates in Arizona, let
29 alone interstate special access rates in Arizona and other states.
- 30 • The Joint CLECs' laundry list of reasons that their costs would be higher than those
31 of the ILECs are not dispositive of any conclusion that their costs are actually higher.
32 In fact, the Joint CLECs have not persuaded any state commission or the FCC that
33 their costs exceed those of the ILEC with whom they compete.
- 34 • CLECs' attempts to postpone access reform and delay its implementation (for them)
35 through a variety of proposals ignore the fact that CLECs have enjoyed eight years in
36 Arizona in which they have not been subject to the partial reform imposed on Qwest's

1 intrastate rates, and ignore the fact that CLECs have known or should have known
2 since 1996 that their intrastate access rates were subject to reductions by regulators.
3 Indeed, CLECs have advised their investors of this risk since at least 1997. If they
4 have not modified their business models in anticipation of this event it is not the fault
5 of Arizona consumers, who should not be made to wait even longer for the benefits of
6 access reform.

- 7 • The CLECs' attempts to inflate the cost of switched access that should be imposed on
8 IXCs by claiming that IXCs are cost-causers of the costs of the loop is no more valid
9 than asserting that IXCs are cost-causers of the cost of a telephone handset—and that
10 IXCs should therefore subsidize handset manufacturers. The CLECs' argument is
11 incorrect and the FCC and economists have long rejected it.

12
13 **Q: DO YOU HAVE ANY OVERARCHING COMMENTS ABOUT THE CLECS'**
14 **DISCOVERY MATERIALS?**

15 **A:** Yes. Since filing my Direct Testimony I have become aware that the average composite
16 access rates provided in discovery by tw telecom were based on calculations performed
17 by tw telecom that I believe are erroneous, and which resulted in tw telecom understating
18 its average intrastate and interstate access rates by about half. Tw telecom calculated its
19 average composite intrastate access rate by dividing its intrastate access revenues not by
20 local switching minutes, as Qwest did and as is common, but by the sum of local
21 switching *plus tandem switching minutes*.⁴ Dividing the access revenues by local
22 switching minutes puts the rate on a called-minute-of-use basis. Tw telecom's approach,
23 which I have never seen used before, has no clear interpretation or meaning. The

⁴ See tw telecom Response to Staff Data Request STF 1.1.

1 resulting rate cannot be compared to Qwest's rate because the rates are not calculated on
2 the same basis.

3 After identifying this error I further researched the rates reported by the LECs. I was able
4 to nearly replicate Qwest's rates using the most recently available ARMIS data. ALECA
5 and the CLECs other than tw telecom did not report sufficient details of their data and
6 their calculations in discovery for me to verify whether or not their calculations are
7 correct or whether they suffer from the same defect as does tw telecom's.⁵ I have asked
8 AT&T to request through the discovery process that the other CLECs provide the
9 necessary additional information underlying their reported average access rates.

10 The figures that I reported in Table 2 of my Direct Testimony were those provided by the
11 CLECs, without any corrections or modifications. Once discovery is received from the
12 CLECs I will be able to examine them and if my concerns are verified by the data I will
13 provide a revised version of Table 2 in the Rejoinder round of testimony.

14 **A. Regulating CLEC Intrastate Rates Is Not "Radical"**

⁵ See CLECs' Responses to Staff Data Request STF 1.1 and ALECA's Response to Staff Data Request STF 1.1.

1 Q: MR. DENNEY ASKS THE COMMISSION TO "BE CAUTIOUS OF TAKING
2 THE RADICAL STEP OF PRICE REGULATING CLECS."⁶ IS REGULATING
3 ACCESS RATES RADICAL?

4 A: No, it is not. In fact, CLECs' interstate access rates have been regulated for years by the
5 FCC, as I noted in my Direct Testimony, and CLECs have intrastate access rate tariffs on
6 file and subject to Commission jurisdiction. Moreover, AT&T's proposed rates are not
7 novel for the CLECs: they are the *same rates that CLECs are already required by the*
8 *FCC to charge, and are presumably already charging, for interstate access.* By setting
9 intrastate rates at interstate levels, the Commission will only be conforming the intrastate
10 rate to the already-required interstate limit for CLECs.

11 Q: BUT IS IT NOT TRUE THAT TA96, WHICH GAVE BIRTH TO CLECS, WAS
12 INTENDED TO REDUCE PRICE REGULATION, AND THAT RECENT
13 TRENDS POINT TOWARD LESS REGULATION AND MORE COMPETITION,
14 AS MR. DENNEY CLAIMS?⁷

15 A: This is true with respect to retail local exchange services. It is not true with respect to
16 switched access services, where the trend has been toward increased rather than decreased
17 price regulation, because reducing switched access charges decreases the distortions and
18 burdens imposed on the telecommunications industry from the legacy regulatory structure
19 of intercarrier transfers that preceded TA96. Requiring CLECs to reduce their excessive
20 access rates is therefore part of and necessitated by the drive toward less regulation and

⁶ Denney Direct Testimony, p. 5.

1 more competition, because competition on the merits cannot be fully achieved as long as
2 some carriers using some technologies must pay monopoly markups on access services
3 while competitors using other technologies do not.

4 The trend toward more, rather than less, regulation with respect to switched access is for
5 good reason—as I explained in my Direct Testimony, both ILECs and CLECs possess
6 market power for both originating and terminating switched access services. The source
7 of this market power does not derive from any entry barriers or failure of competition in
8 the local exchange marketplace. Rather, it stems from legal constraints on differential
9 retail long distance pricing and the institutional idiosyncrasies of the provision of
10 switched access service.⁸

11 **Q: PLEASE EXPLAIN WHY THESE FACTORS CREATE MARKET POWER FOR**
12 **CLECS IN TERMINATING ACCESS.**

13 **A:** When a customer makes a toll call to a particular telephone number, the IXC selected by
14 the originating caller must deliver the call to the terminating LEC that serves the called
15 telephone number, regardless of the price that LEC charges for terminating access. The

⁷ Denney Direct Testimony, p. 5.

⁸ The Joint CLECs hint in discovery that they plan to argue that special access provides adequate competition to switched access so that regulation of switched access rates is unnecessary. See Joint CLECs' First Set of Data Requests, DR.6. This is incorrect. While special access does provide an alternative to switched access for customers who have traffic volumes large enough that it is economical to build or purchase a dedicated facility to bypass the LEC's switch, this alternative cannot provide enough discipline on switched access prices to drive them to cost-based levels. I provided a formal proof of this proposition in AT&T Responses to Joint CLECs' First Set of Data Requests, DR.6, which is attached hereto as Exhibit DJA-R1.

1 IXC does not have a choice of terminating provider. That choice is made solely by the
2 customer receiving the call. However, the IXC must recover the costs that it incurs for
3 switched access expenses in the prices of long distance calls. As long as the IXC must
4 charge the same amount for calls that are terminated to customers of high-access-fee
5 LECs as it does for calls that are terminated to customers of low-access-fee LECs, the
6 LECs have limited incentive to reduce their access fees and limited discipline against
7 increasing them. Each LEC, by unilaterally increasing its access fees, would have a
8 diluted effect on the IXC's overall average costs that it must recover, and therefore would
9 have a diluted effect on long distance prices, and a diluted effect on customer usage. This
10 dilution means that neither the end-user customer placing the call, nor the LEC charging
11 the access fee, is required to confront the full effect of the terminating LEC's price
12 increase, thereby limiting downward pressure on access prices.

13 To understand why the market does not function effectively to discipline access prices, it
14 is useful to describe how the market would have to work in order to create pricing
15 discipline. The way the market would be expected to create pricing discipline in an
16 access market without any regulatory constraints or logistical frictions can be most easily
17 seen with an example.

1 Suppose that LEC A charged 5¢ per minute for terminating access and LEC B charged
2 2¢. Now consider an IXC's customer, Mr. X, making a call to a customer of LEC A.
3 LEC A's terminating access price would affect Mr. X's decision about whether to call his
4 friend, the customer of LEC A if, when he makes the phone call, he receives a real-time
5 message telling him that (i) the party he is calling is a customer of LEC A; (ii) that LEC
6 A charges the IXC 5¢ a minute for the call; and (iii) that this charge will be billed back to
7 Mr. X for this call. In that scenario, Mr. X would have the opportunity to decide not to
8 complete the call (or to shorten the call) and LEC A would lose revenues. In addition,
9 Mr. X could communicate to his friend that he is reluctant to call him because of the high
10 charges assessed by the friend's LEC. Mr. X may also ask his friend to call him back, so
11 that his friend bears the cost of the call himself. These factors would put some (if not
12 perfect) pressure on the customers of LEC A to switch LECs, and therefore some (if not
13 perfect) pressure on LEC A to decrease its access rates.

14 Under these same conditions, if Mr. X were to call a customer of LEC B, the message Mr.
15 X would receive would inform him that this call would cost 2¢ a minute for termination
16 fees (or a usage price that builds in the 2¢ fee), and Mr. X would have less incentive to
17 terminate or shorten the call than he would when calling customers of LEC A. In
18 addition, LEC C may have an incentive (again not a perfect incentive) to offer yet lower
19 access charges in order to appeal to customers who otherwise would find their friends,

1 associates, or customers hesitant to call them. Under these conditions, there would be a
2 mechanism by which LECs with lower terminating rates could attract customers and
3 those with higher rates could lose customers and minutes, thereby imposing some
4 pressure on their terminating access rates.

5 **Q: DO THE CONDITIONS YOU HAVE IDENTIFIED THAT WOULD DISCIPLINE**
6 **THE PRICE OF TERMINATING ACCESS HOLD IN THE MARKETPLACE**
7 **TODAY?**

8 **A:** No. First, I understand that there are no systems in place that could provide callers with
9 the necessary information at the start of each toll call. Thus, the IXC cannot identify for a
10 caller the terminating LEC or its access rate at the start of the call. Second, it is my
11 understanding that even if systems were developed to enable an IXC to pass such
12 information to callers in an acceptably non-intrusive fashion,⁹ IXCs are not permitted to
13 pass along access charges differentially—that is, IXCs are not permitted to charge
14 different prices for long distance service depending on the rates charged by the called
15 party's LEC. As I noted in my Direct Testimony,¹⁰ the Telecommunications Act of 1996
16 requires all IXCs to comply with geographic rate averaging—which applies to both

⁹ It is also necessary for the functioning of this market mechanism that the real-time information system not be unacceptably intrusive from the perspective of customers, because if the pricing information were materially intrusive into the process of making a call, it would be practically infeasible for IXCs to charge the access rates back to their customers even if they are legally able to. Some or all customers would insist on forgoing the information (and the differentiated pricing), perpetuating the situation in which LECs can exert market power in switched access because customers would not have adequate pricing information to make informed, price-responsive decisions.

¹⁰ Aron Direct Testimony, pp. 86-87.

1 intrastate and interstate toll services—and the FCC has instituted a geographic rate
2 averaging policy that precludes IXCs from charging consumers different prices based
3 upon the called or calling party's serving LEC.¹¹

4 These facts defeat the market's ability to impose competitive discipline on terminating
5 access prices.

6 **Q: DOES THE FCC AGREE WITH THIS ANALYSIS?**

7 **A: Yes. As articulated by the FCC:**

8 [I]t appears that the CLECs' ability to impose excessive access charges is
9 attributable to two separate factors. First, although the end user chooses
10 her access provider, she does not pay that provider's access charges.
11 Rather, the access charges are paid by the caller's IXC, which has little
12 practical means of affecting the caller's choice of access provider (and
13 even less opportunity to affect the called party's choice of provider) and
14 thus cannot easily avoid the expensive ones. Second, the Commission has
15 interpreted section 254(g) to require IXCs geographically to average their
16 rates and thereby to spread the cost of both originating and terminating
17 access over all their end users. Consequently, IXCs have little or no ability
18 to create incentives for their customers to choose CLECs with low access
19 charges. Since the IXCs are effectively unable either to pass through
20 access charges to their end users or to create other incentives for end users
21 to choose LECs with low access rates, the party causing the costs – the end
22 user that chooses the high-priced LEC – has no incentive to minimize

¹¹ Report and Order, *Policy and Rules Concerning the Interstate, Interexchange Marketplace and Implementation of Section 254(g) of the Communications Act of 1934, as amended*, Before the Federal Communications Commission, CC Docket No. 96-61, FCC 96-331, (released August 7, 1996), ¶ 9.

1 costs. Accordingly, CLECs can impose high access rates without creating
2 the incentive for the end user to shop for a lower-priced access provider.¹²

3 **Q: DO CLECS HAVE MARKET POWER IN TERMINATING ACCESS EVEN IF**
4 **THE CUSTOMER BEING CALLED HAS MORE THAN ONE TELEPHONE**
5 **PROVIDER?**

6 **A:** Yes. Even when the called party has multiple phone lines (such as wireline and wireless,
7 for example) and the caller can therefore choose between different providers to terminate
8 the call (for example, the caller may be able to choose to call the other party on her
9 mobile phone or wireline phone), the terminating provider retains market power. This is
10 because the IXC must terminate the call to the telephone number called, even if the called
11 party has other telephone numbers using other providers. The IXC does not have the
12 opportunity to choose which of the customer's telephone providers to whom to terminate
13 the call, and the calling customer does not have the incentive to choose the one with the
14 lowest terminating access fees, for the same reasons I have already discussed.

15 **Q: DOES THE FCC AGREE WITH THIS ANALYSIS AS WELL?**

16 **A:** Yes. As the FCC observed in 2005,

¹² Seventh Report and Order and Further Notice of Proposed Rulemaking, *In the Matter of Access Charge Reform and Reform of Access Charges Imposed by Competitive Local Exchange Carriers*, Before the Federal Communications Commission, CC Docket No. 96-262, FCC 01-146, (released April 27, 2001), (hereafter *CLEC Access Charge Reform Order*), ¶ 31. See, also, Notice of Proposed Rulemaking, *In the Matter of Developing a Unified Intercarrier Compensation Regime*, Before the Federal Communications Commission, CC Docket No. 01-92, FCC 01-132, (released April 27, 2001), ¶ 14.

1 Exacerbating the issue of inefficient rates is the problem of terminating
2 access monopolies. Even when an end user takes service from two
3 providers, e.g., wireless and wireline, the originating carrier must deliver
4 the call to the terminating carrier with the telephone number dialed by the
5 calling party. Other carriers seeking to deliver calls to that end user have
6 no choice but to purchase terminating access from the called party's LEC.
7 Originating carriers generally have little practical means of affecting the
8 called party's choice of access provider, and the called party's LEC may
9 take advantage of the situation by charging excessive terminating rates to a
10 competing LEC.¹³

11 **Q: HOW DO CLECS HAVE MARKET POWER IN ORIGINATING ACCESS?**

12 **A:** With respect to originating access, the market power is again not a result of entry barriers
13 or any failure of competition in the local exchange marketplace, but a result of legal
14 constraints on differential pricing and the institutional facts of the marketplace. To
15 discipline prices for originating access, and again considering my same example, the IXC
16 would have to charge a different price for long distance calls if its customer subscribes to
17 LEC A than if he subscribes to LEC B.

18 Hence, confronting the end-user customer with the relevant price signals would require
19 that the IXC could charge different rates to customers purely on the basis of the LEC to
20 which they subscribe, a form of differential pricing that I understand is also not permitted
21 by the same rate averaging rules I referenced earlier. As long as such differential pricing

¹³ Further Notice of Proposed Rulemaking, *In the Matter of Developing a Unified Intercarrier Compensation Regime*, Before the Federal Communications Commission, CC Docket No. 01-92, FCC 05-33, (released March 3, 2005), (hereafter *Intercarrier Compensation Reform FNPRM*), ¶ 24.

1 is not permitted by regulation, customers have no incentive to choose their LEC on the
2 basis of the originating access fee that the LEC charges to IXC's, and the ability of the
3 market to discipline originating access fees is impeded.

4 **Q: MR. DENNEY ARGUES THAT DESPITE THE FCC'S 2001 DECISION TO**
5 **REGULATE CLECS' INTERSTATE ACCESS RATES, A RATE CAP IS NO**
6 **LONGER WARRANTED BECAUSE OF "CHANGES IN THE**
7 **TELECOMMUNICATIONS INDUSTRY"**¹⁴ **UPON WHICH THE FCC**
8 **PREDICATED ITS CONCLUSIONS. HAS HE ACCURATELY**
9 **CHARACTERIZED THE FCC'S VIEWS?**

10 **A:** No. The FCC's analysis of the market for switched access services is consistent with the
11 one I have articulated here, and, as I quoted earlier, the FCC reiterated its conclusion that
12 terminating access is a monopoly at least as recently as 2005, in its *Intercarrier*
13 *Compensation Reform FNPRM*.¹⁵ Mr. Denney argues that in the 2001 *CLEC Access*
14 *Reform Order*, the FCC identified two market "developments" that would "make
15 exchange access (or switched access) markets competitive,"¹⁶ and he argues that these
16 "developments" have now come to pass.¹⁷ In fact, the FCC did not indicate in the 2001

¹⁴ Denney Direct Testimony, pp. 35-39.

¹⁵ See, for example, *Intercarrier Compensation Reform FNPRM*, ¶ 24. Regarding originating access, the FCC has not indicated any retreat from its 2001 conclusion that originating access is a monopoly service (See, *CLEC Access Charge Reform Order*, ¶ 29), and as recently as 2008 then-chairman Martin proposed eliminating originating access charges entirely. See, *2008 NPRM*, Appendix A, ¶ 229.

¹⁶ Denney Direct Testimony, pp. 37-38.

¹⁷ These preconditions are (1) marketing alliances between IXC's and LEC's; and (2) IXC entry into local exchange markets. Mr. Denney cites to ILEC deployment of toll services, once they had received Section 271 approval from the FCC, and the "mergers between major IXC's (and CLEC's) and ILEC's" as evidence that these preconditions have now been met, and concludes that these developments "rebut any suggestion that CLEC's

1 *CLEC Access Reform Order*, or in any other order of which I am aware, that these or any
2 other “market developments,” if they came to pass, would make the access market
3 competitive; on the contrary, the FCC found in the same order that CLECs’ ability to
4 impose excessive access charges “is attributable to” two specific factors: the fact that
5 access charges are paid by the IXC, which has “little practical means of affecting the
6 caller’s choice of access provider,” and regulatory restrictions on rate deaveraging;¹⁸ i.e.,
7 the very same factors I discussed above and which still exist today.

8 The FCC’s subsequent discussions regarding market power for switched access services
9 have continued to focus on the same two factors that it identified in 2001 (and that I
10 identified as the source of CLECs’ market power regarding switched access) and have
11 reiterated the FCC’s conclusions that terminating access is a monopoly service. Indeed,
12 although Mr. Denney makes much of the fact that in the *CLEC Access Reform Order* the
13 FCC characterized its decision to regulate CLECs’ interstate access rates as a
14 “transitional” measure,¹⁹ the fact is that the FCC continues to cap CLECs’ interstate
15 switched access rates, and the FCC’s most recent proposal to reform interstate switched

might exercise market power and prevent IXCs from entering the market.” See, *Denney Direct Testimony*, pp. 38-39.

¹⁸ *CLEC Access Charge Reform Order*, ¶ 31.

¹⁹ *Denney Direct Testimony*, pp. 35-36.

1 access fees in 2008 seeks to implement even more restrictive measures on how ILECs and
2 CLECs price interstate access.²⁰

3 **Q: HAVE STATE COMMISSIONS EVEN MORE RECENTLY REACHED THE**
4 **CONCLUSION THAT CLECS POSSESS MARKET POWER IN THE**
5 **PROVISION OF SWITCHED ACCESS THAT MERITS CONSTRAINTS ON**
6 **THEIR INTRASTATE ACCESS RATES?**

7 **A:** Yes. For example, last year in Massachusetts CLECs made the same arguments as Mr.
8 Denney is putting forward here. The Massachusetts commission rejected them and, as I
9 explain later, ordered CLECs' rates to be capped at the rates of the major ILEC, Verizon.
10 According to the Massachusetts Department of Telecommunications and Cable,

11 Evidence strongly shows that CLECs have market power in providing
12 intrastate switched access service. The unique market characteristics of
13 switched access make it virtually impossible for competition to exist.
14 These same conditions prompted the FCC to cap CLEC rates for interstate
15 switched access in 2001.²¹

16 * * *

17 Given the clear structural failure of the access market with regard to
18 terminating charges, the Department finds that the lack of competitive
19 forces has given CLECs market power. The Department similarly finds

²⁰ 2008 NPRM, Appendix A, ¶¶ 186-206.

²¹ Final Order, *In the Matter of Petition of Verizon New England, Inc., MCI Metro Access Transmission Services of Massachusetts, Inc., d/b/a Verizon Access Transmission Services, MCI Communications Services, Inc., d/b/a Verizon Business Services, Bell Atlantic Communications, Inc., d/b/a Verizon Long Distance, and Verizon Select Services, Inc. for Investigation under Chapter 159, Section 14, of the Intrastate Access Rates of Competitive Local Exchange Carriers*, Before the Commonwealth of Massachusetts Department of Telecommunications and Cable, D.T.C 07-9, (hereafter *2009 Massachusetts Order*), June 22, 2009, p. 9.

1 that in the originating market, the failure of existing competitive forces to
2 discipline rates results in CLECs having market power. The presence of
3 market power overcomes the presumption that CLEC rates are just and
4 reasonable when determined by market forces.²²

5 Similarly, in January of 2010, the New Jersey Board reached similar conclusions. The
6 Board found that

7 [S]witched access service is a monopoly because there is no ability for an
8 IXC or its customers to avoid excessive access charges. The Board
9 concurs with Sprint's argument that LECs have a monopoly over access to
10 their end users, which has permitted a situation where CLECs have
11 charged access rates well above the rates that ILECs charge for similar
12 services.²³

13 * * *

14 [T]here is no material difference in the functionalities used to provide
15 interstate and intrastate switched access and, as a result, any disparities in
16 the Intrastate and Interstate Access Rates should be eliminated.
17 Additionally, the CLECs and ILECs in New Jersey have been charging
18 interstate rates and using interstate rate structures for all interstate calls in
19 New Jersey since the FCC issued its CLEC Rate Cap Order. ... [T]he
20 FCC's approach has been successful and the FCC has not since changed
21 its approach to the pricing of Interstate Access Rates. ... [T]here is no
22 evidence that interstate access rates capped by the FCC eight years ago
23 have caused any CLEC to exit the market.²⁴

²² 2009 Massachusetts Order, p. 17. (Citations omitted.)

²³ Order, *In the Matter of the Board's Investigation and Review of Local Exchange Carrier Intrastate Exchange Access Rates*, Before the State of New Jersey Board of Public Utilities, Docket No. TX 08090830, February 1, 2010, (hereafter *2010 New Jersey Order*), p. 27.

²⁴ *2010 New Jersey Order*, p. 27. (Citations omitted.)

1 Q: DO THE ACTUAL ACCESS PRICES CHARGED BY CLECS APPEAR TO BE
2 DISCIPLINED BY THE MARKET?

3 A: No. According to the Joint CLEC rates computed in Mr. Denney's own testimony, the
4 average intrastate access rate Joint CLECs charge for switched access in Arizona is well
5 over double the average intrastate access rate charged by Qwest.²⁵

6 Moreover, Mr. Denney's assertion that CLEC rates were not reduced after Qwest's
7 reductions because "there was no reason" to²⁶ is an admission of CLECs' market power.
8 If a CLEC competed with the ILEC in the provision of a particular service, there would
9 be downward pressure on its price if the ILEC lowered its own price. If the CLEC has no
10 market power, its prices for switched access service would not be expected to exceed the
11 ILEC's rate in its geographic area *even if it has higher costs*, because customers would
12 not choose to purchase a comparable service at a higher price if they had a choice. The
13 fact that CLECs have sustained higher prices than Qwest and felt "no reason"
14 (in Mr. Denney's words) to respond to Qwest's lower prices by decreasing their own
15 switched access rates is because Qwest's intrastate switched access service does not
16 compete with the CLECs' switched access services and vice versa—i.e., the CLECs
17 possess market power with respect to switched access service.

²⁵ Denney Direct Testimony, Table 1, p. 19. Using Mr. Denney's methodology, Qwest's average rate based on its current intrastate tariffed rates is \$0.018192, compared to an average of \$0.042525 for Joint CLECs (average of terminating and originating rates).

²⁶ Denney Direct Testimony, p. 20.

1 **B. CLECs' Access Rates Should Not Be Exempted from Regulation**

2 **Q: MR. DENNEY ASSERTS THAT "NO PARTY HAS DEMONSTRATED THAT**
3 **CLEC ACCESS RATES ARE UNJUST OR UNREASONABLE."²⁷ IS THAT**
4 **TRUE?**

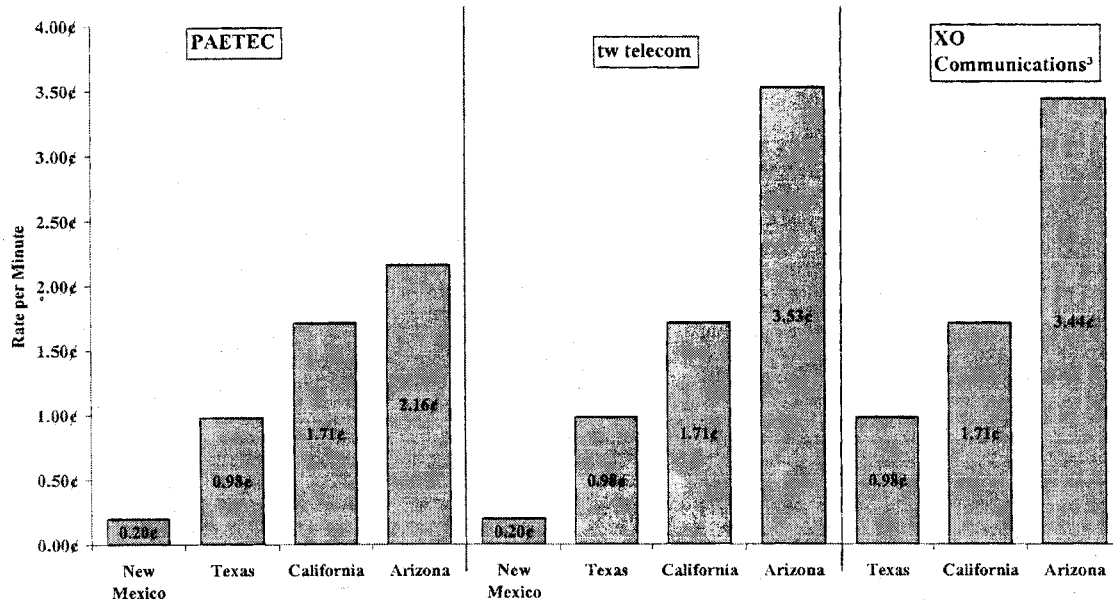
5 **A:** No, it is not. Mr. Denney made his statement before he had seen any of the testimony
6 evidence submitted in this proceeding, so his statement was a bit premature, at best. In
7 fact, I demonstrated in my Direct Testimony that CLECs' intrastate switched access rates
8 are excessive, above Qwest's intrastate rates, and above the rates they themselves charge
9 for the same functionality in Arizona in the interstate jurisdiction.²⁸ Joint CLECs'
10 intrastate rates are also above the rates *they themselves* charge for the same
11 functionality—intrastate switched access—in other, neighboring, states, as exemplified in
12 Figure 1 below.²⁹ I also explained in my Direct Testimony and elaborated here that
13 CLECs possess market power with respect to switched access services. As long as
14 CLECs have market power in the provision of access services, and their rates are
15 demonstrably above those of the ILECs with whom they compete, their rates are not just
16 and reasonable from an economic standpoint, and intervention by the Commission is
17 appropriate.

²⁷ Denney Direct Testimony, p. 18.

²⁸ Aron Direct Testimony, p. 10, Figure 1 and p. 39, Table 2.

²⁹ In Figure 1, I have compared the tariffed Carrier Common Line charge and Local Switching rates in a number of states where Joint CLECs operate. These two elements usually represent the largest portion of access expenses.

Figure 1
Joint CLECs Tariffed Intrastate Rates^{1, 2}



1. Rates shown are the sum of the tariffed CCL charge and the tariffed charge for local switching. Rates are the average of the charges for originating and terminating minutes.

2. Tariffs were not available for Integra in California. Integra does not offer local service in New Mexico or Texas.

3. XO Communications does not offer local service in New Mexico.

Source: Company Tariffs

1 Q: MR. DENNEY PROVIDES A LAUNDRY LIST OF REASONS THAT CLECS'
2 COSTS WOULD BE HIGHER THAN ILECS' COSTS.³⁰ HAS HE
3 DEMONSTRATED THAT CLECS' COSTS ARE IN FACT HIGHER THAN
4 ILECS' COSTS?

5 A: No. Whatever the merits of his observations regarding CLECs' costs, they do not add up
6 to a demonstration that the costs of any CLEC are in fact higher than the costs of any
7 ILEC.³¹ One could list a dozen reasons that water should carry a higher price than
8 diamonds—water is necessary for life and diamonds are not; water is consumed by every
9 person every day, diamonds are not; water has a large variety of uses, diamonds have
10 limited uses, and so forth. While all of these observations are true, they do not add up to
11 a proof that water will (or should) in fact carry a higher price than diamonds. Indeed,
12 they leave out a critical element that would tend to weigh in the other direction; in this
13 case, that diamonds are far more scarce than is water. It turns out that in the marketplace,
14 the scarcity factor outweighs all the others and water is far cheaper per ounce than are

³⁰ Denney Direct Testimony, pp. 26-30.

³¹ In fact, as a purely economic matter, even if CLECs' costs were higher than those of the ILEC, a competitive market would not permit CLECs to charge a higher price than that of the ILEC. Competitive markets do not permit entrants to charge higher prices than those of incumbents simply because (or if) the entrants happen to have higher costs. Such prices would not be viable in a competitive market because for a comparable product, consumers who have a choice would not choose to purchase from a higher-priced provider when they could choose a lower priced one instead. As a general matter, in any industry, entrants who must charge a higher (quality adjusted) price than that of the incumbent in order to cover costs would not survive in a competitive market because customers would not pay the higher price. To compete effectively against an incumbent, competitors with costs that are comparable to the incumbent's must offer at least as good a product; and those with only a comparable product must have comparable or lower costs. Investors in competitors who are working their way through the learning curve or building up scale economies must be willing and able to finance their early years of potential competitive losses while pricing at or below the incumbents' prices. Alternatively,

1 diamonds. Similarly, Mr. Denney's list of factors that would make CLECs' costs higher
2 than ILECs' costs excludes, for example, the countervailing facts that CLECs are not
3 burdened with legacy technologies and legacy network architectures, and that CLECs can
4 choose the specific geographic areas in which to build and serve, can serve other areas
5 without building a network (via resale, for example), or can choose not to serve some
6 areas at all. Whether any CLEC's costs are actually higher than any ILEC's costs, or vice
7 versa, is an empirical question that cannot be demonstrated by listing some factors that
8 would tend to weigh in one direction; rather, it would have to be demonstrated by actually
9 measuring costs.³²

10 **Q: MR. DENNEY ARGUES THAT CLECS HAVE A DIFFERENT NETWORK**
11 **ARCHITECTURE AND GENERATE "MORE TRAFFIC SENSITIVE COSTS TO**
12 **RECOVER VIA THEIR SWITCHED ACCESS RATES COMPARED TO**
13 **ILECS."**³³ **DOES THE FACT THAT CLECS CHOSE A DIFFERENT NETWORK**
14 **ARCHITECTURE FROM ILECS IMPLY THAT CLECS' COSTS ARE**
15 **HIGHER?**

16 **A:** No. CLECs configured their networks differently from ILECs presumably because the
17 chosen architecture is more efficient, not less efficient, than the ILECs' architecture,
18 given the scale and location of each CLEC's footprint. That more efficient architecture

competitors with higher costs, as the Joint CLECs purport to have, would have to justify higher retail prices with a better retail product or service.

³² In fact, in some states CLECs are permitted to demonstrate that their costs are higher than the ILECs' costs of providing switched access in order to exceed the ILEC's intrastate access rates. AT&T asked in discovery whether the Joint CLECs have ever made a cost showing that permitted them to charge access rates based on

1 might involve tradeoffs between the costs of different components of the network. As an
2 analogy, a car owner may choose to purchase more expensive tires if the better tires are
3 expected to improve gas mileage by enough to outweigh the additional costs of the tires.
4 The fact that this car owner purchased more expensive tires does not mean that the cost of
5 driving her car is higher than those of her neighbor who spent less on tires—rather, a
6 comparison would require a full analysis of what kind of car her neighbor owns, what
7 grade of gasoline it takes, and numerous other factors. Similarly, whatever the tradeoffs
8 faced by the CLECs between traffic sensitive and non traffic sensitive elements of their
9 network configurations, each CLEC rationally would have chosen its network
10 configuration because any other one, including that of the ILECs, would have resulted in
11 higher costs overall for that CLEC given its geographic footprint and customer
12 characteristics.

13 **Q: IS IT “CONFISCATORY” OR “HARMFUL [TO] LOCAL COMPETITION” TO**
14 **REGULATE CLECS’ SWITCHED ACCESS RATES, AS MR. DENNEY**
15 **CLAIMS?³⁴**

16 **A:** No. Where markets are competitive, the market is far better at picking winners and
17 losers, allocating resources, and setting prices, than is regulation. CLECs face significant
18 competition for retail local exchange services in Arizona, and it is appropriate to impose

their costs. In their responses, the Joint CLECs did not identify any such instances. See Joint CLECs’
Responses to AT&T Discovery Request No. ATT 1-12.

³³ *Denney Direct Testimony*, pp. 29-30.

1 minimal restrictions on CLECs' retail prices. These competitive forces do not translate to
2 effective competition for switched access services in light of the other regulatory
3 constraints and institutional facts of the market, however, and therefore it is consistent
4 with sound, welfare-enhancing public policy principles to constrain the CLECs' market
5 power over access services using rate caps on intrastate access prices. Doing so is not
6 confiscatory and would advance, not harm, competition.

7 **Q: MR. DENNEY ARGUES THAT RBOCS' INTERSTATE RATES ARE NOT AN**
8 **APPROPRIATE TARGET FOR CLEC RATES BECAUSE CURRENT**
9 **INTERSTATE RATES WERE SET WITHOUT CLEC INPUT.³⁵ IS THAT**
10 **TRUE?**

11 **A: No. Qwest's current interstate access rates were set in the CALLS proceeding in 2000, as**
12 **I explained in my Direct Testimony. While CLECs were not part of the negotiations that**
13 **led to Qwest's rates, CLECs did participate in the proceeding that led to the adoption of**
14 **the rates that were negotiated, and they *supported the rates that were ultimately set.***
15 **Specifically, the Association for Local Telecommunications Services ("ALTS"), a**
16 **coalition of CLECs, and another Joint CLEC member, tw telecom (then, Time Warner**
17 **Telecom), proposed reducing ILECs' interstate access rates to the same target rates as the**
18 **rates proposed by CALLS consortium, just more slowly.³⁶ Joint CLEC members XO,**

³⁴ Denney Direct Testimony, pp. 33-35.

³⁵ Denney Direct Testimony, p. 30.

³⁶ Sixth Report and Order in CC Docket Nos. 96-262 and 94-1, Report And Order in CC Docket No. 99-249, Eleventh Report and Order in CC Docket No. 96-45, *In the Matter of Access Charge Reform and Price Cap*

1 PAETEC, and tw telecom were ALTS members at the time ALTS filed its comments,³⁷
2 and tw telecom (Time Warner Telecom) additionally filed separate comments.

3 **Q: SHOULD THE COMMISSION BE CONCERNED THAT THE CURRENT ILEC**
4 **RATES SET IN THE CALLS PROCEEDING WERE "ARBITRARY" AND WITH**
5 **"NO SOLID COST FOUNDATION," AS MR. DENNEY SUGGESTS?³⁸**

6 **A:** No. First of all, the FCC did in fact consider cost studies in adopting the CALLS rates,
7 and it explained that one of the reasons it considered the CALLS rates to be just and
8 reasonable was that they were within the range of estimated economic costs of switched
9 access that were in cost studies presented to the Commission.³⁹ Second, AT&T does not
10 seek to lower intrastate rates all the way to ILECs' costs of providing switched access
11 service at this time, but rather to adopt a more modest reduction to interstate rates.

12 **Q: MR. DENNEY ARGUES THAT SWITCHED ACCESS RATES SHOULD**
13 **REFLECT COMPANY-SPECIFIC COSTS BECAUSE "IT IS STANDARD**
14 **PRACTICE TO SET REGULATED RATES FOR WHOLESALE SERVICES**

Performance Review for Local Exchange Carriers et al., Before the Federal Communications Commission, CC Docket Nos. 96-262 and 94-1 et al., FCC 00-193, (released May 31, 2000), (hereafter *FCC CALLS Order*), ¶ 178. See also, Joint Comments of the Association for Local Telecommunications Services and Time Warner Telecom, *In the Matter of Access Charge Reform and Price Cap Performance Review for Local Exchange Carriers et al.*, Before the Federal Communications Commission, CC Docket Nos. 96-262 and 94-1 et al., April 3, 2000, p. 18 and Exhibit; and Joint Reply Comments of the Association for Local Telecommunications Services and Time Warner Telecom, *In the Matter of Access Charge Reform and Price Cap Performance Review for Local Exchange Carriers et al.*, Before the Federal Communications Commission, CC Docket Nos. 96-262 and 94-1 et al., April 17, 2000, p. 7.

³⁷ See Joint CLECs' Responses to AT&T Data Request ATT 1-8. Integra states in its Discovery Response that it "does not believe that ELI was a member" of ALTS, but ALTS own list of members as of March 2000 indicates that Electric Lightwave was a member at the time. See "ALTS Network Members," at <http://web.archive.org/web/20000301204750/www.alts.org/frames/aboutalts.htm> (accessed January 27, 2010).

³⁸ *Denney Direct Testimony*, pp. 32-33.

³⁹ *FCC CALLS Order*, ¶ 176.

1 [SUCH AS UNBUNDLED NETWORK ELEMENTS] BASED ON COMPANY
2 SPECIFIC COSTS.”⁴⁰ IS IT “STANDARD PRACTICE” THAT REGULATED
3 RATES FOR WHOLESALE SERVICES PROVIDED BY CLECS BE SET AT
4 CLECS’ COSTS?

5 A: No. CLECs are not required to provide unbundled network elements and therefore there
6 is no “standard practice” by which CLECs’ prices for unbundled network elements would
7 be set. The only wholesale service for which I am aware that a “standard practice” exists
8 with respect to CLEC rates is interstate switched access. There the standing and
9 nationwide paradigm is the one ordered by the FCC in which CLECs’ interstate switched
10 access rates are capped by the interstate rates of the ILEC in its service territory.

11 **C. Joint CLECs’ Proposal to Benchmark CLECs’ Intrastate Access Rates at**
12 **Qwest’s 1999 Level Is Without Merit and Ignores the Joint CLECs’ Own**
13 **Disclosures to Their Shareholders**

14 Q: PLEASE COMMENT ON JOINT CLECS’ PROPOSAL TO USE QWEST’S 1999
15 INTRASTATE ACCESS RATES AS A “BENCHMARK” IF THE COMMISSION
16 DECIDES ON A TARGET OTHER THAN COST.⁴¹

17 A: This proposal has no logical or economic merit. Mr. Denney’s first argument is that the
18 rates in 1999 were the ones that “would have been considered” when CLECs decided to
19 enter the market. Whether this is true or not, however, and Mr. Denney provides no
20 evidence that it is, it does not justify Mr. Denney’s proposal. There was never any
21 implicit or explicit promise by regulators that access rates would remain unchanged, and

⁴⁰ Denney Direct Testimony, pp. 39-40.

1 any CLEC that entered the market on the basis of a business plan that required the CLEC
2 to receive a perpetual, never-changing monopoly revenue stream from access rates is not
3 a CLEC that regulators should seek to protect. It is not the job of regulators to protect
4 business plans that are founded on the exploitation of regulatory protections for
5 monopoly services, rather than on superior efficiencies and superior services. Moreover,
6 any CLEC that entered the market believing that intrastate access rates would not change
7 would have been irrational, given that access rates were changing in the interstate arena.⁴²
8 If CLECs were somehow deluded into thinking that their access rates would never be
9 regulated or decreased (and they were not, as I demonstrate shortly), they certainly should
10 have been disabused of that notion by 2001, when CLECs' access rates were capped in
11 the interstate arena, and in subsequent years as CLECs' intrastate rates were in fact
12 decreased in numerous other states, as I have already documented. In fact, for the Joint
13 CLECs themselves, their intrastate rates are lower than Qwest's current Arizona intrastate
14 rates in other nearby states, including New Mexico and Texas, as documented above in
15 Figure 1.⁴³

16 **Q: ACCORDING TO MR. DENNEY, A REDUCTION IN INTRASTATE ACCESS**
17 **RATES WILL FORCE CLECS TO CHANGE THEIR BUSINESS PLANS,**

⁴¹ *Denney Direct Testimony*, p. 49.

⁴² See, for example, McLeodUSA Incorporated, Form 10-K, for the fiscal year ended December 31, 1997, p. 23; and Time Warner Telecom Inc. Form 10-K, for the fiscal year ended December 31, 1999, pp. 20-21.

⁴³ The sum of Qwest's current intrastate local switching and CCL charge is 1.63¢ in Arizona. See Qwest Corporation Access Service Price Cap Tariff, §§ 3.8, 6.8.2.

1 **WHICH HAVE BEEN IMPLEMENTED “OVER THE PAST TEN PLUS**
2 **YEARS.”⁴⁴ IS THIS PLAUSIBLE?**

3 A: No. Any CLEC that has not accounted in its business plan for the possibility of
4 reductions in access rates can only be considered irresponsible to its shareholders.
5 CLECs not only should have known but demonstratively have known for at least the last
6 13 years that access rates are subject to reduction, and should have incorporated this in
7 their business plans well before now. Publically traded companies in the US are required
8 by securities regulations to advise their shareholders of all material risks to the business,
9 and they typically provide their shareholders with a long list of possible risks that could
10 befall their business in their annual 10-K filings with the SEC. The SEC disclosures
11 made by the Joint CLECs since 1997 make clear that all of the joint CLECs have been
12 well aware of the exposure of access rates to regulatory reductions since at least that time,
13 and have put investors on notice of possible reductions in switched access rates in both
14 the interstate and the intrastate jurisdictions throughout the last decade. Table 1, which is
15 attached as Exhibit DJA-R2, is a sample of such statements from the companies' 10-Ks.

16 In some instances, CLECs have warned their investors that the effect of changes in access
17 rates is unknown. CLECs have stated in other instances that they do not expect the effect
18 to be material; that it may also benefit the CLEC's business through lower access

⁴⁴ *Denney Direct Testimony*, p. 5. Mr. Garrett similarly urges the Commission to delay reform efforts, in order to

1 expenses; or that business plans reflect a downward trend in access rates. In all cases, the
2 CLECs have indicated that they have considered the effects of potential reductions to
3 access rates and have incorporated that risk into their business judgment and analysis.

4 While the CLECs properly and repeatedly notified their shareholders that they faced
5 possible access rate reductions and that the effect on their businesses was uncertain (the
6 standard language associated with such disclosures), the CLECs have not provided any
7 evidence in this proceeding (or anywhere else to my knowledge) that they actually have
8 left any state in which interstate or intrastate access rates were in fact reduced over the
9 last decade. When asked in discovery to provide support for the contention that a policy
10 to cap CLECs' access rates has curtailed their ability to compete or expand their network,
11 Mr. Denney admitted that he had not performed any analyses to arrive at this conclusion,
12 and the CLECs provided no evidence or examples that they have curtailed any activities
13 (let alone exited a state) as a result of access rates caps in any state.⁴⁵

14 Hence, the Joint CLECs' suggestion that they are entitled to Qwest's 1999 intrastate
15 access rates is simply without merit and inconsistent with the reasonable duty of any
16 public company to its shareholders to have conducted its business over the last decade to

⁴⁵ "ensure that business models can evolve." See, *Garrett Direct Testimony*, p. 8. The same response applies.
See Joint CLECs' Responses to AT&T Data Request ATT 1-9.b through 1-9.e.

1 best manage, anticipate, and respond as the business environment and business risks
2 change and evolve.

3 **Q: WHAT IS MR. DENNEY'S OTHER ARGUMENT IN SUPPORT OF HIS**
4 **PROPOSAL THAT CLECS' INTRASTATE ACCESS RATES BE CAPPED, IF**
5 **NOT AT "COST," AT QWEST'S 1999 INTRASTATE RATES?**

6 **A:** Mr. Denney argues that the decreases in Qwest's intrastate rates were the result of
7 revenue neutral settlement agreements entered into by Qwest, and there is no justification
8 to apply those decreases to CLECs.⁴⁶

9 **Q: IS THAT A VALID ARGUMENT?**

10 **A:** No, absolutely not. First, the "revenue neutral" decreases in Qwest's intrastate access
11 rates were offset by increases in retail prices⁴⁷ that had artificially been held below cost.⁴⁸
12 To the extent that CLECs compete with the ILECs, their retail prices compete with the
13 ILECs' retail prices, and an increase in the permitted retail rate that an ILEC can charge
14 creates more competitive opportunities for CLECs as well. Hence, an increase in the
15 retail price cap for the ILEC creates the opportunity for CLECs to increase prices as well,
16 or to win more customers from the ILECs by maintaining their prices at current levels, or
17 adopting an intermediate strategy between the two.

⁴⁶ Denney Direct Testimony, p. 49.

⁴⁷ Opinion and Order, *In the Matter of Qwest Corporation's Filing of Renewed Price Regulation Plan and In the Matter of the Investigation of the Cost of Telecommunications Access*, Before the Arizona Corporation Commission, Docket Nos. T-01051B-03-0454 and T-00000D-00-0672, March 23, 2006, p. 7.

1 Second, for reasons that I have discussed above and in my Direct Testimony, and as the
2 FCC has explained as well, as an economic matter CLECs' access rates should be no
3 greater than those of the ILEC with which they compete. A competitive market would
4 not permit a competitor with an equivalent service to charge a price that is higher than
5 that of the incumbent, regardless of the competitor's costs.

6 **D. The Cost of the Loop Is Not a Cost of Switched Access nor Properly**
7 **Included in the Price of Switched Access**

8 **Q: MR. DENNEY ARGUES THAT LOOP COSTS SHOULD BE INCLUDED IN**
9 **SWITCHED ACCESS COSTS BECAUSE IXCS "BENEFIT FROM THE LOCAL**
10 **LOOP."⁴⁸ IS THIS A VALID ARGUMENT?**

11 **A:** No. If one were to estimate the costs of providing switched access it would be incorrect
12 to include costs of the local loop. When an IXC purchases switched access service, the
13 functionality provided is call origination or termination. The costs of providing those
14 functions do not include costs of the loop. The costs of the loop are independent of the
15 usage on the loop, and, most important, are *dedicated to a particular customer*.
16 Therefore, the economically efficient way to recover the costs of the loop is in the form of
17 a flat rate paid by the customer to whom the loop is dedicated. The fact that long distance

⁴⁸ Qwest's Response to Staff Data Request 1.24.c.

⁴⁹ Denney Direct Testimony, pp. 61-62. Dr. Johnson makes a similar argument. See Johnson Direct Testimony, pp. 16-17.

1 service "benefit[s] from the local loop" does not alter this result and provides no
2 justification for a subsidy imposed on long distance providers to support the loop.

3 Such an argument is essentially the same as arguing that, because long distance customers
4 require the use of a handset (paraphrasing Mr. Denney's logic) in order to place or receive
5 a long distance call, and such customers "benefit from the use of the handset," that long
6 distance companies should subsidize the customer's handset. Handset manufacturers
7 might argue that long distance companies require the use of the handset to provide their
8 service, so long distance companies should be required to pay a fee to the handset
9 manufacturer for every minute of long distance usage to help recover the costs of the
10 handset. Their argument would be that if long distance companies (and, for the same
11 reasons, local exchange companies) are not required to pay a fee to handset manufacturers
12 for every minute of a long distance or, respectively, local call made using that handset,
13 the service providers are getting a free ride—after all, the call cannot be made without the
14 use of the handset and the cost of the handset is a "shared" cost between local and long
15 distance service. The fallacy in this argument is the same one as the fallacy in the
16 CLECs' argument regarding the loop: the cost of *furnishing* a handset, like the cost of
17 furnishing a loop, is independent of the *usage* on the handset, and the handset is
18 *dedicated* to a particular household. The efficient recovery of the cost of the handset is
19 that the customer pay a flat (not usage-sensitive) price for it to the company that built the

1 handset, and use it for as much or as little service as she likes—however much she may
2 use local or long distance service. There would be no justification for requiring IXCs to
3 pay a per minute fee to Panasonic or Motorola for the recovery of handset costs based on
4 how much their customers use the handset for long distance service. The same principles
5 hold for recovery of the costs of furnishing the loop.

6 **Q: DO ECONOMISTS AGREE WITH YOU THAT LOOP COSTS ARE NOT**
7 **ATTRIBUTABLE TO SWITCHED ACCESS SERVICE?**

8 **A:** Yes. The debate over this issue was effectively put to bed well over a decade ago by
9 renowned regulatory economist Alfred Kahn and co-author William Shew:

10 Using the price of telephone calls to recover access costs that do not in fact
11 vary as more or fewer calls are made... induces wasteful choices by
12 customers. It encourages them to order underpriced access lines that they
13 value less than the incremental costs to society of providing the lines, and
14 it discourages them from making overpriced calls whose value to them
15 would have exceeded the incremental cost to society. The same result
16 would follow if an electric utility were to supply its customers with all the
17 appliances they wanted at no charge and recovered the costs in the price of
18 electricity -- wasteful overpurchasing of appliances and underconsumption
19 of electricity.⁵⁰

20
⁵⁰ Alfred E. Kahn and William B. Shew, "Current Issues in Telecommunications Regulation: Pricing," *Yale Journal on Regulation* 4 (Spring 1987), p. 202. (Footnotes omitted.) See also, David L. Kaserman and John W. Mayo, "Cross-Subsidies in Telecommunications: Roadblocks on the Road to More Intelligent Telephone Pricing," *Yale Journal on Regulation* 11 (Winter 1994), p. 125; ("Efficient (and intelligent) telephone pricing therefore requires a two part tariff. A fixed monthly charge, independent of usage, should recover the fixed costs of providing customer access to the network. A usage based charge for both local and long-distance services equal to the marginal costs of the respective services would recover usage sensitive costs.")

1 **Q: DOES THE FCC AGREE WITH YOU THAT LOOP COSTS ARE NOT**
2 **ATTRIBUTABLE TO SWITCHED ACCESS SERVICE?**

3 **A:** Yes, the FCC long ago rejected the argument posited by Mr. Denney. As early as 1982,
4 the FCC established the goal of recovering non-traffic-sensitive loop costs through flat
5 rates to end-users:

6 A subscriber who obtains a line to a local dial switch or a manual
7 switchboard necessarily obtains access to interstate as well as local
8 services. The cost of that access has traditionally been described as non-
9 traffic sensitive because such costs do not vary with usage. A subscriber
10 who does not use the subscriber line to place or receive calls imposes the
11 same NTS costs as a subscriber who does use the line. A subscriber who
12 does not make local calls would normally pay a flat fee for the exchange
13 portion of such costs. Imposing a flat charge for the interstate portion of
14 those costs is equally reasonable. Any other procedure violates the general
15 principle that costs should be recovered from the cost-causative ratepayer
16 whenever it is possible to do so.⁵¹

17 **E. Mr. Denney's Appeal to Ad Hominem Assertions of "Hypocrisy" and**
18 **"Insincerity" Are Incorrect and Reflect a Misunderstanding of the Economics**
19 **of the Situation**

⁵¹ Third Report and Order, *In the Matter of MTS and WATS Market Structure*, Before the Federal Communications Commission, FCC 82-579, (released February 28, 1983), ¶ 121.

1 Q: MR. DENNEY OPINES THAT THE IXCS' CALLS TO REDUCE ACCESS
2 RATES IN ARIZONA ARE "HYPOCRITICAL AND SELF-SERVING,"
3 CLAIMING THAT "OF COURSE, AT&T IS NOT WILLING TO FORGO ITS
4 SWITCHED ACCESS REVENUE."⁵² IS THAT TRUE?

5 A: No. AT&T is proposing rate reductions for all LECs, including the rates AT&T itself
6 charges as a CLEC in Arizona. The Joint CLECs, in contrast, are asking the Commission
7 to leave their own rates unchanged while reducing the rates of other LECs.

8 Q: MR. DENNEY ATTACKS THE "SINCERITY" OF AT&T'S PROPOSAL ON
9 THE GROUNDS THAT, ACCORDING TO MR. DENNEY, IF AT&T REALLY
10 THOUGHT INTRASTATE RATES WERE TOO HIGH, IT COULD HAVE
11 UNILATERALLY REDUCED ITS INTRASTATE RATES TO THE LEVEL IT IS
12 ADVOCATING IN THIS PROCEEDING.⁵³ IS THAT A VALID ARGUMENT?

13 A: No. Mr. Denney's facile argument fails to comprehend the economics of the situation.
14 Like all LECs, including each of the Joint CLECs, AT&T as a CLEC has market power
15 over switched access to its customers. If other LECs with whom AT&T competes are
16 allowed to price switched access at above-cost prices, it would be irresponsible to its
17 shareholders for AT&T to forgo the same opportunity. From AT&T's perspective,
18 reducing its own access rates when its competitors were permitted to fully exploit their
19 market power with higher prices would only leave money on the table, while generating
20 no additional demand (because, again, switched access service is a monopoly service and
21 retail long-distance prices reflect average, not individual, access rates). Moreover, not

⁵² Denney Direct Testimony, pp. 40-41.

1 only would it not be in AT&T's interest to unilaterally reduce its intrastate access rates, it
2 would not create meaningful social welfare benefits for AT&T to unilaterally reduce the
3 intrastate access rates it charges in Arizona. This is because if AT&T *were* the only
4 CLEC to decrease its access rates, there would be minimal effect on IXCs' long distance
5 prices because IXCs must average their prices rather than respond to the access rates of
6 individual LECs, as I explained earlier. One CLEC alone reducing its access rates would
7 have minimal effect on the average rate paid by IXCs. Hence, it would be neither in
8 AT&T's interests, nor meaningfully benefit consumers, for AT&T to unilaterally (i.e., on
9 its own, without similar action by the other LECs) reduce its access rates.

10 This is why regulatory intervention is necessary. In a competitive market it would be in a
11 company's own interests to reduce its price toward cost because it could benefit from the
12 increased demand it could thereby draw away from its competitors. In the provision of
13 switched access, the competitive mechanism is not functional and LECs, including the
14 Joint CLECs and AT&T, cannot be expected to voluntarily reduce their switched access
15 rates. By imposing the regulatory requirement that *all* LECs must reduce access rates,
16 however, there would be a meaningful reduction in the average access rate paid by IXCs,
17 and one would therefore expect retail long distance prices to fall, as I demonstrated in my
18 Direct Testimony. Customers would benefit; the requirement would be competitively

⁵³ Denney Direct Testimony, p. 42.

1 neutral as between LECs; and IXCs would be able to compete with other technologies on
2 a more level playing field.

3 **Q: MR. DENNEY ALLEGES THAT QWEST ARIZONA CHARGES RATES FOR**
4 **INTERSTATE AND INTRASTATE SPECIAL ACCESS THAT SIGNIFICANTLY**
5 **EXCEED COSTS, AS DOES AT&T ILLINOIS FOR INTERSTATE SPECIAL**
6 **ACCESS.⁵⁴ PLEASE COMMENT.**

7 **A:** Whether or not there is any merit to his assertions (which I have not analyzed), they have
8 no relevance to whether good public policy dictates reducing rates for ILECs' and
9 CLECs' intrastate switched access services in Arizona. The scope of this case does not
10 include special access prices. The Commission's jurisdiction does not even cover
11 *interstate* special access, and it certainly does not cover interstate special access *in*
12 *Illinois*. Whether Qwest or any other ILEC earns "significant revenues" on intrastate
13 special access in Arizona does not affect the benefits to consumers of reducing ILECs and
14 CLECs intrastate switched access rates. Mr. Denney's discussion of special access rates
15 is merely a distraction.

16 **F. Intrastate Access Reform Should Not Be Delayed Any Longer**

17 **Q: MR. DENNEY URGES THE COMMISSION TO DELAY OR REFRAIN**
18 **ENTIRELY FROM ANY REFORM THAT WOULD AFFECT THE JOINT**
19 **CLECS, BECAUSE THE ISSUES ARE "COMPLICATED" AND EACH**
20 **CARRIER HAS "ITS OWN CUSTOMER AND BUSINESS INTEREST." HE**

⁵⁴ Denney Direct Testimony, pp. 44-47.

1 **PROPOSES THAT THE COMMISSION “[DEAL] FIRST” ONLY WITH**
2 **“AREAS OF CONSENSUS.”⁵⁵ PLEASE COMMENT.**

3 A: Contrary to Mr. Denney’s urging, the Commission certainly understands that it is not its
4 job to rubber stamp the “areas of consensus” between some parties in a proceeding, or to
5 acquiesce to each carrier’s “business interest,” but rather to act in the interest of
6 consumers. Consumers would be best served in this proceeding by requiring all wireline
7 local exchange carriers to decrease their rates for intrastate access to their interstate
8 levels. Whatever the “complexity” of the issues for future, additional federal access
9 reform, requiring the reduction of CLEC and ILEC access rates is a measure that the FCC
10 *has already taken* after extensive analysis and the levels to which CLECs and ILECs
11 would reduce their intrastate rates under AT&T’s proposal are rates that the carriers,
12 including the CLECs, *are already charging for the same functionality in the interstate*
13 *jurisdiction.*

⁵⁵ *Denney Direct Testimony*, p. 16.

1 Q: MR. DENNEY CITES TO A RECENT FCC PUBLIC NOTICE IN SUPPORT OF
2 HIS RECOMMENDATION THAT THE COMMISSION WAIT FOR A RULING
3 BY THE FCC ON INTERCARRIER COMPENSATION RATHER THAN ACT
4 NOW.⁵⁶ DO YOU AGREE THAT REFORM AT THE STATE LEVEL SHOULD
5 BE DELAYED?

6 A: No. First, despite Mr. Denney's assertion that the FCC "really [does] plan to address
7 intercarrier compensation,"⁵⁷ he makes no attempt, nor can he, to predict *when* that might
8 actually happen. The recent FCC public notice to which he points is another in a line of
9 public notices and notices of proposed rulemaking in the last eight years in which the
10 FCC has sought input on intercarrier compensation reform. For example,

- 11 • Notice of Proposed Rulemaking in CC Docket No. 01-92, released April 27,
12 2001 (seeking comment on the feasibility of a bill-and-keep approach for a
13 unified intercarrier compensation regime and seeking alternative comment on
14 modifications to existing intercarrier compensation regimes)
- 15 • Public Notice in CC Docket No. 01-92, released October 18, 2002 (seeking
16 comment on two petitions that request rulings regarding the intercarrier
17 compensation regime applicable to certain types of wireless traffic)
- 18 • Further Notice of Proposed Rulemaking in CC Docket No. 01-92, released
19 March 3, 2005 (continuing the ongoing re-examination of intercarrier
20 compensation and seeking comments on specific proposals developed by a
21 number of industry groups)
- 22 • Public Notice in CC Docket No. 01-92, released July 25, 2006 (seeking
23 comment on the "Missoula Plan," filed by the National Association of
24 Regulatory Utility Commissioners' Task Force on Intercarrier Compensation)
- 25 • Public Notice in CC Docket No. 01-92, released November 8, 2006 (seeking
26 comment on a proposed interim process to address "phantom traffic")

⁵⁶ Denney Direct Testimony, p. 15.

⁵⁷ Denney Direct Testimony, p. 15.

- Public Notice in CC Docket No. 01-92, released February 16, 2007 (seeking comment on amendments to the Missoula Plan that incorporate a proposal addressing issues faced by “early adopter” states)
- Further Notice of Proposed Rulemaking in CC Docket No. 01-92, et al., released November 5, 2008 (seeking comment on certain intercarrier compensation and universal service issues, including three specific proposals) and Public Notice issued on November 12, 2008 establishing the comment dates for the three proposals contained in the NPRM

In fact, the public notice to which Mr. Denney referred is not even part of the long-standing intercarrier compensation docket (CC Docket 01-92) but part of another docket addressing the broadband plan.⁵⁸ There has been no public filing from the FCC regarding its intercarrier compensation docket since the November 2008 filings, which were issued under the previous administration. Hence, there is no basis for concluding that the FCC is going to act in any predictable time frame, and certainly there is no reason for the Commission to delay necessary and long-overdue reform in Arizona that merely catches up to decisions the FCC made nearly a decade ago.

Q: MR. DENNEY PROPOSES THAT ACCESS RATE REDUCTIONS BE IMPLEMENTED GRADUALLY, OVER AT LEAST EIGHT TO TEN YEARS.⁵⁹ WHAT IS THE BASIS FOR THIS APPEAL?

A: Mr. Denney offers a number of reasons:

1. CLECs are small and cannot absorb financial losses as easily as Qwest.⁶⁰

⁵⁸ Denney Direct Testimony, p. 15, footnote 19.

⁵⁹ Denney Direct Testimony, pp. 51-52. Mr. Denney proposes an initial phase of three years with no access charges reductions, and a subsequent period of phased-in reductions of five to seven years.

2. A gradual reduction would minimize the impact on end users.⁶¹
3. The FCC's CLEC interstate caps were implemented in three years, and the FCC's most recent NPRM proposes a ten-year transition.⁶²
4. CLECs serve primarily business customers and have term contracts with almost all of them, with an average term of 4.2 years, and would not be able to modify retail rates for term customers.⁶³
5. Many LECs buy wholesale services from AT&T and Verizon that may contain term commitments, and since IXC's have not committed to flow through access charge reductions, immediate implementation could "result in a windfall" for IXC's.⁶⁴
6. CLECs are more vulnerable to mandatory reductions because business customers generate higher calling volumes than residential customers.⁶⁵

Q: DO YOU CONSIDER ANY OF THESE ARGUMENTS TO BE PERSUASIVE?

A: No. I have considered each and have not found any to have merit, and I will respond to each in turn. I note first, however, that aside from the defects in his arguments, Mr. Denney completely ignores the fact that the CLECs have been exempt from access reform in Arizona for the last eight years during which the main ILEC has been subject to access rate reductions. Therefore, while Qwest's excessive access rates demand further reform now, CLEC reform is even more overdue and does not merit additional delays and avoidance.

⁶⁰ Denney Direct Testimony, pp. 50-51.

⁶¹ Denney Direct Testimony, p. 51.

⁶² Denney Direct Testimony, p. 51.

⁶³ Denney Direct Testimony, p. 52.

⁶⁴ Denney Direct Testimony, p. 53.

⁶⁵ Denney Direct Testimony, p. 53.

1 **Q: PLEASE EXPLAIN THE DEFECTS IN MR. DENNEY'S ARGUMENT THAT**
2 **CLECS ARE SMALL AND CANNOT ABSORB FINANCIAL LOSSES AS**
3 **EASILY AS QWEST CAN.**

4 **A:** First, the proposed access reform amounts to replacing a monopoly revenue stream from
5 IXCs with the opportunity to earn revenue in the competitive market. To the extent that
6 CLECs compete with the ILECs, their retail prices compete with the ILECs' retail prices,
7 and an increase in the permitted retail rate that an ILEC can charge creates more
8 competitive opportunities for CLECs as well, as I explained earlier. Hence, there is no
9 necessary "financial loss" associated with the proposed access reform unless the CLECs
10 are not able to compete effectively in the retail market. The necessity of all LECs to
11 compete effectively in the retail market is a social benefit of access reform, not a defect.

12 Second, Mr. Denney seems to think it is relevant that the CLECs' global revenues are
13 relatively small in comparison to the ILECs' global revenues (and AT&T's global
14 revenues),⁶⁶ but fails to note that the CLECs' global revenues are actually extremely large
15 in comparison to a more relevant statistic: the amount of access revenues potentially at
16 stake for them in this proceeding. In fact, to the extent that "financial loss" is relevant at
17 all, the more relevant fact than the comparisons offered by Mr. Denney is that for each of
18 the Joint CLECs, the reduction in their access revenues under AT&T's proposal would be
19 far less than half a percent of their total revenues, and on average would be *less than one*

1 *tenth of one percent* of their total revenues.⁶⁷ And that is before one even considers the
2 CLECs' opportunities to recover at least some of those access reductions through
3 rebalancing local rates or other business measures.

4 **Q: WOULD IT "MINIMIZE THE IMPACT" TO END USERS TO ALLOW AN**
5 **EIGHT TO TEN YEAR TRANSITION PERIOD FOR ACCESS RATE**
6 **REDUCTIONS, AS MR. DENNEY CLAIMS?**⁶⁸

7 **A:** Yes, in the sense that it would minimize the *benefits* that consumers would otherwise
8 enjoy as a result of access reform. It would also perpetuate the already-excessive amount
9 of time that the uneconomically high intrastate access rates in Arizona have distorted
10 competition across long distance technologies. Finally, it would extend the already-
11 excessive amount of time that CLECs in Arizona have had to charge inflated intrastate
12 access rates rather than be required to earn those revenues in the competitive retail
13 marketplace. Consumers have paid unnecessarily high rates for intrastate long distance
14 service in Arizona for the last ten years as a result of intrastate access rates that exceed
15 interstate access rates. CLECs have been granted a reprieve during that time because only
16 Qwest was required to make any access rate reductions. While a sound access reform

⁶⁶ Denney Direct Testimony, Table 3.

⁶⁷ For Integra, it would be 0.23 percent of its total 2008 revenues; for PAETEC, it would be 0.02 percent; for tw telecom, 0.16 percent; for XO Communications, 0.04 percent; and for all Joint CLECs taken together the loss would be 0.09 percent of their total 2008 revenues. The figures for PAETEC, XO Communications, and Integra are based on the average rates provided by the CLECs in response to Staff's Data Request STF 1.1, which are subject to revision, as I explained above.

⁶⁸ Denney Direct Testimony, pp. 9, 51.

1 policy would permit ILECs (and potentially, therefore, CLECs) to increase retail prices
2 for local service to balance the access revenue reductions, the net effect would be positive
3 and beneficial for consumers for all the reasons that I articulated in my Direct Testimony.

4 **Q: DIDN'T THE FCC PROVIDE FOR A GRADUAL DECLINE IN CLECS'**
5 **INTERSTATE ACCESS RATES RATHER THAN DROP THE CLEC RATE**
6 **IMMEDIATELY IN THE CLEC ACCESS REFORM ORDER?**

7 **A:** Yes, the FCC gave CLECs up to three years to reduce their interstate rates to those of the
8 ILEC with whom they compete,⁶⁹ far *less* than the eight to ten years that the Joint CLECs
9 are requesting here, for reductions on a far *greater* proportion of their access revenues
10 than are at issue today. CLECs sell many times more interstate access minutes than
11 intrastate access minutes,⁷⁰ so a substantially greater share of their access revenues were
12 at stake when they underwent interstate access reductions resulting from the FCC's 2001
13 Order.

14 Today there is no reason for any gradual decline. In 2001, the FCC believed that it
15 needed to provide a transition period to allow CLECs to adjust their business plans
16 because they had not been "held to the regulatory standards imposed on ILECs."⁷¹

17 Today, however, CLECs have been subject to interstate rate caps at ILEC levels for eight
18 years; they are subject to intrastate rate caps in numerous states; they have been on notice

⁶⁹ CLEC Access Charge Reform Order, ¶ 52, and 47 CFR §§ 61.26 (b) and (c).

⁷⁰ See individual CLEC Responses to Staff Data Request STF 1.1.

1 at least since the FCC's *CLEC Access Reform Order* in 2001 that the regulatory
2 landscape was moving toward capping CLEC access rates; and they have been informing
3 their shareholders accordingly over these many years, as I demonstrated earlier. CLECs
4 have had ample time to adjust their business plans to this reality.

5 **Q: MR. DENNEY ARGUES THAT IF THERE ARE TO BE ANY ACCESS RATE**
6 **REDUCTIONS THEY SHOULD BE PHASED IN OVER "AT LEAST" FIVE TO**
7 **SEVEN YEARS, BECAUSE CLECS "TYPICALLY" HAVE LONG TERM**
8 **CONTRACTS WITH THEIR CUSTOMERS WITH TERMS THAT ARE**
9 **"OFTEN" FIXED DURING THE TERM OF THE AGREEMENT.⁷² IS THIS A**
10 **VALID REASON TO PHASE IN ACCESS RATE REDUCTIONS?**

11 **A:** No. First, I note that the Joint CLECs declined to provide these contracts in discovery, on
12 the grounds (among others) that they are not relevant to this proceeding.⁷³ If they are
13 irrelevant to this proceeding they cannot form the basis of the Joint CLECs' argument
14 that access reform should be delayed. The Joint CLECs' refusal to provide the contracts
15 precludes me from examining them and testing Mr. Denney's claim by determining to
16 what extent CLECs in fact "typically" have long term contracts and how common it is
17 that they "often" have fixed terms.

18 In any event, contracts with customers (at the wholesale or retail level) are common in
19 our economy across numerous industries. All companies that enter into contracts that last

⁷¹ *CLEC Access Charge Reform Order*, ¶¶ 61-62.

⁷² *Denney Direct Testimony*, pp. 51-52.

⁷³ Joint CLECs' Response to AT&T Data Request ATT 1-5.

1 a meaningful period of time do so recognizing both the benefits and risks of locking into
2 terms. The benefits to the seller include the certainty of the agreed-upon demand flow
3 and prices; the benefits to the buyer include the certainty of the price and of a committed
4 supplier. The risks to the buyer include the fact that market prices may fall, making the
5 contract a poor deal. The risks to the seller include the fact that input costs may rise,
6 reducing the profitability of the agreed-upon price. In some cases contracts include
7 language that allows the price, quantity, or other terms to be modified depending on
8 observed market events or other factors. In all cases, a rational firm entering a contract
9 will incorporate into the price to which it agrees some adjustment for the risks it is
10 assuming. For example, it would be rational to build in a risk premium to a price that is
11 locked in by contract over several years, to compensate the seller for the possibility that
12 input costs will rise during the contract term (and weighed against the possibility that
13 input costs will fall and profits will be higher than expected). The buyer would normally
14 be willing to pay some premium for being insulated from that pricing risk, and one would
15 expect the contracted price in a competitive market to reflect these risk considerations.

16 The risk to CLECs that access rates may fall is no different in economic terms than the
17 risks that companies in any industry face when they make long term contracts that their
18 input prices may rise, availability of inputs may fall, revenues from other services may
19 fall, the legal environment may change, and so forth. As I have discussed, CLECs

1 certainly were aware of the possibility of access rate reductions. If they did not build
2 terms into their contracts that explicitly permitted the price to change in the event of
3 access rate changes, they certainly had every opportunity to lock in contracted prices that
4 incorporated a premium for the risks they faced.

5 **Q: DO THE CLECS' ARGUMENTS SUPPORT THEIR DEMAND FOR A**
6 **TRANSITION PERIOD OF FIVE TO SEVEN YEARS, OR EVEN MORE?**

7 **A:** No. Even aside from the fact that CLECs have an obligation to their shareholders to lock
8 themselves into contracts with customers only to the extent they have agreed to prices that
9 reflect and manage their risks, the time period they demand is unconnected to the facts
10 they cite. Mr. Denney claims that McLeod has contracts with "virtually 100%" of its
11 customers, and that the average agreement term is 4.2 years.⁷⁴ He does not say what
12 percentage of these contracts have fixed pricing terms, only indicating that CLECs'
13 contracts "often" have fixed terms. Even if every single McLeod contract had fixed terms
14 (which presumably is not the case, or Mr. Denney would have said so), the average
15 agreement life of 4.2 years means that approximately 25 percent of McLeod's customers
16 roll off contract every year. In two years after an access rate change approximately half of
17 all customers who were under contract at the time of the change would have rolled off

⁷⁴ *Denney Direct Testimony*, p. 52.

1 their contracts,⁷⁵ and that does not account for new customers that McLeod would have
2 added after the change was made. It also does not account for the fact that some, many,
3 or perhaps most of the CLECs' contracts do permit pricing terms to change in response to
4 changes in the CLECs' costs, so the only customers with whom the CLECs are locked
5 into prices are those with whom the contract does not allow for pricing modifications in
6 relevant circumstances. In fact, this proceeding in Arizona has been preceded by two
7 years of workshops and industry discussion, so that most CLEC customers will have
8 already rolled off of any contracts they entered into before this process began in Arizona.
9 Hence, nothing in the figures provided by Mr. Denney supports his request for an
10 arbitrarily long transition period.

11 **Q: MR. DENNEY ARGUES THAT CLECS "COULD BE MORE VULNERABLE"**
12 **THAN ILECS TO ACCESS RATE REDUCTIONS BECAUSE BUSINESS**
13 **CUSTOMERS "CAN GENERATE HIGHER CALLING (AND ACCESS)**
14 **VOLUMES THAN RESIDENTIAL CUSTOMERS," AND CLECS FOCUS ON**
15 **BUSINESS CUSTOMERS MORE THAN DO ILECS.⁷⁶ DOES THIS**
16 **OBSERVATION HELP THE CLECS' CASE?**

17 **A: No. In fact, according to the CLECs' discovery responses, none of the Joint CLECs**
18 **serves residential customers.⁷⁷ They serve business customers only. Historically, as I**

⁷⁵ This assumes that the actual contract life of customers under contract is 4.2 years, with no variability. If there is variability in contract life with average over the different contracts being 4.2 years, one would expect *even more* to have rolled off in two years.

⁷⁶ Denney Direct Testimony, p. 53.

⁷⁷ See XO Response to AT&T Data Request AT&T 2.1; tw telecom Response to AT&T Data Request AT&T 2.1; Integra Responses to Staff Data Request STF 1.3 and to AT&T Data Request 2.6; and PAETEC Response to

1 discussed in my Direct Testimony, it was residential customers that required subsidies, in
2 order to keep retail residential rates acceptably low from a policy standpoint. Retail local
3 exchange prices to business customers have historically been a *source* of cross-subsidy,
4 not a recipient. That is, historically, business rates were set by regulators at above-cost
5 levels to cross-subsidize residential prices. The historical justification for excessive
6 access rates simply does not apply to CLECs because the public policy rationale was
7 never to subsidize retail business services. Hence, the admission that these CLECs serve
8 only business customers further exposes the fallacy of the Joint CLECs' arguments.
9 Their proposal protects the Joint CLECs and their business customers at the expense of
10 residential (and business) customers of IXCs.

11 **Q: MR. DENNEY FURTHER ASSERTS THAT IMMEDIATE REDUCTIONS IN**
12 **ACCESS RATES "COULD RESULT IN A WINDFALL" TO IXCS BECAUSE**
13 **SOME LECS PURCHASE WHOLESALE SERVICES FROM IXCS UNDER**
14 **TERM COMMITMENTS.⁷⁸ IS THIS A LEGITIMATE CONCERN?**

15 **A:** No. I have not been provided the opportunity to review any such contracts, but regardless
16 of their terms the evidence does not support Mr. Denney's assertion.⁷⁹ The regression
17 that I presented in my Direct Testimony showed that access reductions were reflected in

Staff Data Request STF 1.3. See also Joint CLECs' Response to AT&T Data Request ATT 1-17. PAETEC does not market to residential customers or offer service to new residential customers.

⁷⁸ Denney Direct Testimony, pp. 52-53.

⁷⁹ Joint CLECs were asked to provide all term commitment contracts with their wholesale long distance providers that are currently in effect, but they refused to do so. See Joint CLECs' response to AT&T's Data Request ATT 1-6.

1 lower retail prices *within one year* of the access charge reduction.⁸⁰ The data show that,
2 despite any term contracts into which CLECs may have entered in their operations around
3 the country, the market response to access rate reductions has in fact been retail rate
4 reductions.

5 In addition, as I have already noted, CLECs should have been and indeed were aware of
6 intrastate access charge proceedings which resulted in access charge reductions in other
7 states and of the risk of access charge reductions. These risks should have been
8 incorporated into the contract prices or conditions of the contract, either implicitly or
9 explicitly.

10 **G. Mr. Denney's Claims that IXCs Will Not Flow Through Access Rate**
11 **Reductions Are Not Supported by Any Facts and Are Contradicted by the**
12 **Data**

13 **Q: ACCORDING TO MR. DENNEY, IXCS WILL NOT NECESSARILY FLOW**
14 **THROUGH ACCESS COST REDUCTIONS TO ARIZONA CONSUMERS.⁸¹**
15 **PLEASE COMMENT.**

16 **A:** While the Joint CLECs offer speculation and unsupported assertions, I provided sound,
17 empirical evidence in my Direct Testimony based on the actual behavior of long distance
18 prices and access rates over a number of years and 50 states that IXCs do reduce long
19 distance prices when access prices are reduced. I also explained in my Direct Testimony

⁸⁰ See Aron Direct Testimony, pp. 60-65.

1 that even an unregulated monopolist would decrease its retail prices in response to a
2 decrease in its variable costs (as a reduction in access rates is), because it would be profit-
3 maximizing to do so.⁸² The expectation that decreased access rates would result in
4 decreased retail long distance prices is not reliant on any assumptions about how
5 competitive the long distance market is, or on any assumptions about any carriers' market
6 power or lack thereof. Regardless of the degree of competitiveness, the profit motive
7 drives companies to lower prices when variable costs fall.

8 **Q: MR. DENNEY ARGUES THAT THE IXCS HAVE MONOPSONY POWER WITH**
9 **RESPECT TO SWITCHED ACCESS SERVICE,⁸³ AND THEREFORE THEY**
10 **SHOULD NOT BE PERMITTED TO NEGOTIATE CONTRACT RATES FOR**
11 **SWITCHED ACCESS. DOES THE FCC AGREE WITH MR. DENNEY THAT**
12 **IXCS HAVE "MONOPSONY POWER"?**

13 **A:** No. The FCC explicitly rejected this argument in the *CLEC Access Charge Reform*
14 *Order*, concluding that the evidence did not support it. The FCC further concluded in
15 that Order that antitrust laws are available "to protect CLECs from the exploitation of any
16 monopsony power that IXC's may possess."⁸⁴

⁸¹ Denney Direct Testimony, p. 64.

⁸² Aron Direct Testimony, pp. 66-67.

⁸³ Denney Direct Testimony, pp. 55-57.

⁸⁴ CLEC Access Charge Reform Order, ¶ 85.

1 **III. Response to the Direct Testimony of Douglas Garrett on behalf of Cox Arizona**
2 **Telcom**

3 **Q: MR. GARRETT ASSERTS THAT "REDUCING ACCESS CHARGES WILL**
4 **ONLY EXACERBATE THE DILEMMA OF MAINTAINING A COMPETITIVE**
5 **NETWORK," BECAUSE "ACCESS LINES AND MINUTES OF USE ARE ON A**
6 **STEADY DOWNWARD TRACK."⁸⁵ WILL REDUCING ACCESS RATES**
7 **EXACERBATE THE PROBLEM OF MAINTAINING THE NETWORK?**

8 **A: No. Mr. Garrett fails to recognize that even aside from the inefficiencies, competitive**
9 distortions, and improperly placed burdens associated with the current regime of
10 supporting local exchange service with implicit subsidies from access rates, access rates
11 are simply no longer a reliable mechanism for subsidizing the local loop *because* of the
12 declines in access lines and minutes of use. As ALECA has made clear,⁸⁶ the declines in
13 access minutes are causing the traditional source of funding for the local network to dry
14 up and a more reliable and economically rational system of telecommunications pricing is
15 necessary.

⁸⁵ Garrett Direct Testimony, p. 4.

⁸⁶ "The Case for Arizona Access Charge Reform," Arizona Local Exchange Carrier Association White Paper, November 2, 2006, (hereafter 2006 ALECA White Paper), pp. 6-7.

1 Q: MR. GARRETT OF COX URGES THE COMMISSION TO DELAY ACCESS
2 REFORM BECAUSE "ONLY BY RATIONALIZING RATES UNDER A
3 NATIONAL FRAMEWORK CAN...ARBITRAGE BE CURTAILED OVER
4 TIME."⁸⁷ PLEASE COMMENT.

5 A: Mr. Garrett has it backwards. Reducing intrastate access rates in Arizona to interstate
6 rates, as AT&T proposes, is precisely what is necessary to reduce arbitrage, because
7 arbitrage opportunities are created by rates that are excessive relative to costs, and by
8 rates that are different from each other. AT&T's proposal will reduce both forms of
9 arbitrage. Doing nothing while waiting for the FCC to act will certainly not decrease
10 arbitrage opportunities in Arizona, particularly while other states are reducing arbitrage
11 opportunities in their states by reforming their own intrastate access rates. Moreover,
12 contrary to the assertion of Mr. Garrett, there is absolutely no reason that a national
13 framework is needed in order to reduce arbitrage opportunities in Arizona—reducing
14 intrastate rates to interstate levels in Arizona will reduce arbitrage opportunities in
15 Arizona.

16 Q: MR. GARRETT ASSERTS THAT "CHANGING RATES IN ONE
17 JURISDICTION WILL LIKELY HAVE NO EFFECT ON THE RATES
18 ARIZONA CONSUMERS PAY."⁸⁸ IS THIS TRUE?

19 A: No. Mr. Garrett's unsupported speculation is again belied by the data. The facts are, as I
20 explained in my Direct Testimony, that states that have lower intrastate access rates have

⁸⁷ Garrett Direct Testimony, p. 5.

1 lower retail intrastate long distance prices on average and states with higher average
2 intrastate access rates have higher intrastate long distance prices, on average.

3 **Q: MR. GARRETT FURTHER ASSERTS THAT ACCESS REFORM "CANNOT BE**
4 **SUCCESSFUL ON A STATE-BY-STATE BASIS" AND THEREFORE THE**
5 **COMMISSION MUST WAIT FOR A "NATIONAL FRAMEWORK."⁸⁸ PLEASE**
6 **COMMENT.**

7 **A:** I would suggest that consumers in states that have reduced intrastate access rates, and are
8 experiencing substantially lower prices on average for intrastate long distance service,
9 would prefer to have those benefits now rather than waiting for the possibility that the
10 FCC might someday institute a full, nationwide plan of access reform even though the
11 FCC's efforts have produced no results for years. While a nationwide, comprehensive
12 plan is desirable, the straightforward plan proposed by AT&T—which only reconciles
13 intrastate rates with the interstate rates that were established in the federal jurisdiction
14 nearly a decade ago and, by all signals, will be reduced much further in future federal
15 access reform plans—can give consumers substantial relief now, reduce distortions, cause
16 long distance prices to fall in Arizona, reduce arbitrage, increase efficiency, and enhance
17 competition.

⁸⁸ *Garrett Direct Testimony*, p. 5.

⁸⁹ *Garrett Direct Testimony*, p. 6.

1 IV. Response to the Direct Testimony of Douglas Duncan Meredith on Behalf of
2 ALECA

3 Q: PLEASE SUMMARIZE YOUR RESPONSE TO ALECA'S TESTIMONY.

4 A: ALECA correctly identifies the competitive and public policy distortions created by
5 currently excessive access rates, but its proposed solution is not adequate to address the
6 problems it identifies. ALECA proposes to reduce LECs' intrastate access rates to
7 Qwest's composite intrastate rate. But every problem that it identifies would be better
8 addressed by reducing intrastate access rates to interstate levels. Indeed, ALECA itself
9 asserted in its 2006 White Paper, "In order to provide immediate Arizona access rate
10 reform, the intrastate composite rate *needs to be at the level of the interstate composite*
11 *rate.*"⁹⁰

12 In addition, ALECA argues that there should be no increases to retail prices, and that
13 revenues forgone as a result of its proposed access reductions should be recovered
14 entirely through draws from an Arizona Universal Service Fund. However, recovering all
15 forgone access revenues from a universal service fund rather than at least partially
16 through increases in retail rates would perpetuate a subsidy system by which retail prices
17 are kept inefficiently low, merely broadening the source of subsidy from IXC's to all

⁹⁰ 2006 ALECA White Paper, p. 9. (Emphasis added.) See also ALECA Response to Staff's First Set of Data Requests, STF 1.10. ("The rural ILECs believe unifying the intrastate and interstate access rates and rate structures is the appropriate action to take.")

1 telecommunications customers who support the USF fund. While broadening the base of
2 support for the subsidy (by reducing intrastate access rates and recovering the forgone
3 revenues through USF draws) would reduce the competitive distortions associated with
4 the funding of the subsidy, and would therefore be an improvement over the current
5 system, recovering all forgone access revenues from a USF fund would unduly perpetuate
6 a variety of other inefficiencies and distortions. A superior solution would be to recover
7 part or all of the forgone access revenues by providing LECs the opportunity to increase
8 retail local exchange prices to a benchmark, as I explained in detail in my Direct
9 Testimony. ALECA has not attempted to demonstrate that some increase in retail prices
10 would make their services unaffordable, and therefore there is no reason to reject a
11 benchmark approach. Certainly, the vast differences in basic local rates across the
12 ALECA members suggests that at least some members could increase rates without any
13 adverse effect on telephone penetration.

14 **Q: WHAT ARE MR. MEREDITH'S ARGUMENTS FOR HIS RECOMMENDATION**
15 **TO REDUCE THE COMPOSITE INTRASTATE RATE OF EACH ALECA**
16 **MEMBER TO QWEST'S COMPOSITE INTRASTATE RATE?**

17 **A:** According to Mr. Meredith, reducing carriers' intrastate access rates to Qwest intrastate
18 rate would (i) "promote equity between urban/suburban and rural areas of the state;" (ii)
19 provide a simple and straightforward target rate, because Qwest's composite rate is

1 publicly available; and (iii) lessen the burden of the AUSF relative to the burden that
2 would be incurred if rates are reduced to interstate levels.⁹¹

3 **Q: DOES A REDUCTION OF ALECA MEMBERS' INTRASTATE RATES TO**
4 **QWEST'S INTRASTATE LEVELS BEST PROMOTE "EQUITY"?⁹²**

5 **A:** No. A policy under which all ILECs decrease their intrastate access rates to their own
6 interstate rates is more equitable *to consumers* because it would result in a greater overall
7 average reduction in intrastate access rates and would thereby reduce the competitive
8 inequity between wireline long distance and wireless carriers. It would also eliminate the
9 arbitrage opportunities associated with the differences between intrastate and interstate
10 rates by making those rates equal to each other for each carrier. It would impose the same
11 policy on all carriers, including Qwest, and conform that policy to the federal policy that
12 has been in place for many years.

13 **Q: DOES ALECA AGREE WITH YOU THAT INTRASTATE ACCESS CHARGES**
14 **MUST BE BROUGHT DOWN TO INTERSTATE LEVELS IN ORDER TO**
15 **REFLECT THE MODERN COMPETITIVE ENVIRONMENT?**

16 **A:** Yes. According to ALECA's white paper,

17 In response to the Montana Public Service Commission inquiry into
18 matters concerning intercarrier compensation, the Montana
19 Telecommunications Association stated: "the differences in intrastate
20 and interstate access charges can no longer be sustained in a

⁹¹ Meredith Direct Testimony, p. 7.

⁹² Meredith Direct Testimony, p. 7.

1 competitive environment, especially where technology has enabled
2 telephone calls to circumvent access charges altogether” and providing as
3 an example that “intra-MTA wireless traffic is subject to reciprocal
4 compensation and is responsible for significant reduction in local
5 exchange carrier intrastate access revenues” and that “VoIP traffic
6 currently avoids access payments altogether.” **ALECA agrees with this**
7 **observation** and believes that the pace of market changes necessitates
8 prompt action in Arizona. Without action over time there will be an
9 increased burden on end-user customers because end-user customers will
10 bear an increased cost burden, which left unchecked will likely raise
11 affordability issues in rural areas.⁹³

12 **Q: WOULD IT BE MORE “SIMPLE” OR “STRAIGHTFORWARD” FOR ALECA**
13 **MEMBERS TO USE QWEST’S INTRASTATE RATE AS A TARGET RATE**
14 **THAN THEIR OWN INTERSTATE RATES?**⁹⁴

15 **A:** No. I am aware of no reason that it would be simpler for an ALECA member to try to
16 mirror the composite intrastate rate of a different carrier operating in a different area than
17 to mirror its own interstate rates, which it has already tariffed and which it is already
18 charging. If anything, common sense suggests that it would be much easier to implement
19 the simple plan proposed by AT&T, because all LECs have already implemented that
20 same plan for interstate traffic.

⁹³ 2006 ALECA White Paper pp. 6-7. (Footnotes omitted, emphasis added.)

⁹⁴ Meredith Direct Testimony, p. 7.

1 **Q: ALECA OBSERVES THAT REDUCING SWITCHED ACCESS RATES WILL**
2 **REDUCE OR ELIMINATE THE INCENTIVE FOR ARBITRAGE.⁹⁵ PLEASE**
3 **COMMENT.**

4 **A:** The only way to eliminate the incentive for arbitrage between interstate and intrastate
5 access rates is to make them equal. Reducing ALECA carriers' (or CLECs') intrastate
6 rates to Qwest's intrastate rate would not eliminate this form of arbitrage and therefore
7 would not achieve one of the public policy goals of access reform. As ALECA correctly
8 observed in discovery:

9 Unifying or equalizing the rates for each jurisdiction [intrastate and
10 interstate] will remove the incentive for carriers to provide incomplete call
11 detail records or to seek routing alternatives that do not match the
12 originating jurisdiction of a call. Moving to Qwest's intrastate access rates
13 would not address rate arbitrage encouraged by an individual company's
14 variance between intrastate and interstate access rates.⁹⁶

15 **Q: ALECA ARGUES THAT ESTABLISHING A BENCHMARK FOR RETAIL**
16 **LOCAL EXCHANGE SERVICE PRICES IN ORDER TO ACHIEVE REVENUE**
17 **NEUTRALITY WOULD ONLY "ADD COMPLICATIONS," AND THAT ALL**
18 **LOST ACCESS REVENUE SHOULD BE FUNDED THROUGH A UNIVERSAL**
19 **SERVICE FUND.⁹⁷ PLEASE COMMENT ON THIS PROPOSAL.**

20 **A:** As I explained in my Direct Testimony, recovering any forgone access revenues through a
21 universal service fund perpetuates inefficient and distorted retail prices by, for example,
22 burdening urban consumers, including those with relatively low incomes, in order to

⁹⁵ Meredith Direct Testimony, p. 12.

⁹⁶ ALECA Response to Staff Discovery First Set of Data Requests, STF 1.10. See, also, Meredith Direct Testimony, p. 6.

1 subsidize rural customers, even those with relatively high incomes. Establishing a
2 benchmark involves conducting a pricing analysis of the type that is certainly within the
3 normal purview of a regulatory commission and consistent with its obligations and
4 expertise. The Commission would do a disservice to Arizona consumers if it were to
5 decline to establish a reasonable benchmark in this case—and instead impose all revenue
6 recovery on a state universal service fund—on the grounds that establishing a benchmark
7 would be “complicated.” Mr. Meredith surely underestimates the Commission’s
8 expertise by suggesting it.⁹⁸

9 **V. Response to the Direct Testimony of Lisa Hensley Eckert on Behalf of Qwest**

10 **Q: PLEASE DESCRIBE YOUR UNDERSTANDING OF QWEST’S THEORY OF**
11 **THIS CASE.**

12 **A:** I begin by observing that Qwest admits to several key points that validate the opinions I
13 reached in my Direct Testimony and that validate AT&T’s position in this case that
14 intrastate access rates should be reduced to interstate levels. Qwest admits that:

- 15 1. Access rates were historically established to include, and do today include,
16 significant subsidy elements.⁹⁹

⁹⁷ *Meredith Direct Testimony*, p. 8.

⁹⁸ In fact, the Commission’s Staff apparently does not consider establishing a benchmark to be unduly complicated, insofar as Staff proposes establishing one for each carrier rather than the simpler approach proposed by AT&T of a single statewide benchmark. See *Shand Direct Testimony*, Executive Summary, ¶ 6.

⁹⁹ *Eckert Direct Testimony*, p. 4. See also Qwest’s Response to Staff Data Request 1.24.

2. Excessive access rates distort competition and cause inefficiency.¹⁰⁰
3. Reducing excessive access rates will decrease fraud and regulatory
arbitrage.¹⁰¹

In addition, Qwest agrees that:

4. Terminating switched access is a monopoly service whether provided by an
ILEC or CLEC¹⁰² and
5. CLECs should not be permitted to charge switched access rates above an
appropriate ILEC-determined benchmark.¹⁰³

Hence, Qwest does not dispute that excessive access rates cause inefficiency. Qwest specifically suggests that the Commission require other carriers to decrease their intrastate access fees (i.e., the fees that the Qwest long distance entity pays when its customers make intrastate calls to customers of other LECs in Arizona) to Qwest's intrastate rates.¹⁰⁴

Qwest objects, however, to a requirement to reduce its own intrastate rates, on the grounds that the Commission already addressed Qwest's rates in its Price Cap Plan.¹⁰⁵

¹⁰⁰ Eckert Direct Testimony, pp. 4-6.

¹⁰¹ Eckert Direct Testimony, p. 17.

¹⁰² Eckert Direct Testimony, p. 5.

¹⁰³ Eckert Direct Testimony, p. 7.

¹⁰⁴ Eckert Direct Testimony, p. 7.

¹⁰⁵ Eckert Direct Testimony, p. 5.

1 Q: IS THIS A SOUND BASIS FOR PERPETUATING EXCESSIVE, DISTORTING
2 INTRASTATE ACCESS RATES?

3 A: No. The facts to which Qwest admits are more than sufficient for the Commission to
4 conclude that it would be in the public interest to require Qwest to reduce its intrastate
5 rates to its interstate levels. There is no economic or policy justification in the context of
6 this proceeding for Qwest's excessive and distorting intrastate rates to be perpetuated.

7 Q: MS. ECKERT ARGUES THAT QWEST'S INTRASTATE SWITCHED ACCESS
8 RATE IS THE "IDEAL" TARGET LEVEL FOR ALL LECs IN ARIZONA.¹⁰⁶
9 DO YOU AGREE?

10 A: No, I do not. Qwest's proposal has no principled basis, and it has two sizable flaws: first,
11 there is no reason that the rates should be capped at Qwest's intrastate rate rather than its
12 interstate rate, and second, there is no sound basis for capping rates of LECs who operate
13 in territories other than Qwest's ILEC territory at Qwest's rates.

14 Ms. Eckert offers a number of arguments in support of Qwest's proposal: Qwest's access
15 rates are the lowest tariffed rates in the state; Qwest is the largest ILEC in Arizona;
16 targeting all rates to Qwest's level would mirror the FCC mandate; many other states
17 have followed this approach; and Qwest's rate is a commonly stated objective of access
18 agreements between IXC's and CLEC's.¹⁰⁷ Additionally, Ms. Eckert argues that intrastate

¹⁰⁶ Eckert Direct Testimony, p. 7.

¹⁰⁷ Eckert Direct Testimony, pp. 7-8.

1 access rates should be uniform across the entire state to truly reduce arbitrage
2 problems.¹⁰⁸ None of these arguments holds water.

3 **Q: SHOULD THE COMMISSION ESTABLISH QWEST'S INTRASTATE RATE AS**
4 **THE TARGET BECAUSE QWEST'S RATES ARE THE LOWEST IN THE**
5 **STATE?**¹⁰⁹

6 A: No. Qwest's intrastate access rates are not the lowest rates in the state for originating and
7 terminating functionality. In fact, Qwest's intrastate access rates are the *highest* rates that
8 *Qwest itself* charges in Arizona for the functionality of call origination and termination.
9 As I demonstrated in my Direct Testimony,¹¹⁰ Qwest's interstate access rates are lower
10 than its intrastate access rates, and its reciprocal compensation rates are lower still, all of
11 which are charged for the *same* functionality. AT&T's proposal that Qwest reduce its
12 intrastate rates to its interstate levels is not the extreme one of driving intrastate access
13 rates all the way to its reciprocal compensation rates (or, as the FCC proposed in 2008,
14 beyond that to zero) at this time; but neither is it the policy of inaction proposed by Qwest
15 in which Qwest, the largest carrier in the state, would make no reductions at all, even
16 though it already charges substantially lower rates for the same functionality in Arizona,
17 differentiated only by the regulatory category of the service.

¹⁰⁸ Eckert Direct Testimony, p. 7.

¹⁰⁹ Eckert Direct Testimony, p. 7.

¹¹⁰ Aron Direct Testimony, Figure 1 and Table 1.

1 Q: IS IT REASONABLE TO REQUIRE ALL LECs TO SET THEIR RATES AT
2 QWEST'S LEVEL BECAUSE QWEST IS THE LARGEST ILEC IN
3 ARIZONA?¹¹¹

4 A: No, the fact that Qwest is the largest ILEC in the state is why Qwest *must* reduce its
5 excessive intrastate rates for the full benefits of access reform to be enjoyed by residents
6 of Arizona. As I explained in my Direct Testimony, IXCs cannot discriminate in their
7 retail prices on the basis of the identity of the LEC serving the customer to whom they are
8 terminating, or from whom they are originating, traffic. Hence, retail prices respond to
9 the *average* access rate paid by the IXC. If the largest ILEC in the state does not reduce
10 its intrastate access rates, the effect on the state-wide average rate of the other reductions
11 taken by the other carriers will be muted. The effect on reducing intrastate long distance
12 prices will therefore be similarly muted, diminishing the benefit to long distance
13 customers and diminishing the benefits to intermodal competition.

14 Q: DOES QWEST'S PROPOSAL MIRROR THE FCC MANDATE, AS MS.
15 ECKERT ASSERTS?¹¹²

16 A: No. Mirroring the FCC mandate would be for each ILEC to charge the rate ordered by
17 the FCC for the same functionality in the interstate jurisdiction, and for each CLEC to
18 charge the same rate as the ILEC in the territory where it competes. That is what the FCC
19 ordered, and that is AT&T's proposal.

¹¹¹ Eckert Direct Testimony, pp. 7-8.

1 Q: WOULD HAVING A UNIFORM RATE ACROSS THE STATE TEND TO
2 REDUCE ARBITRAGE, AS MS. ECKERT CLAIMS?¹¹³

3 A: No, uniformity per se across the state for intrastate access is not the relevant factor. As I
4 explained earlier in response to ALECA, it is not diversity of rates across areas of the
5 state that induces arbitrage; it is the fact that rates are excessive in relation to the costs of
6 providing the service, and the fact that rates for a given carrier diverge between
7 functionally identical services. Reducing intrastate rates to interstate levels would
8 eliminate the potential for arbitrage via traffic-shifting between the interstate and
9 intrastate jurisdictions. It would also reduce the difference between intrastate rates and
10 costs, thereby reducing cost-price arbitrage opportunities.¹¹⁴

¹¹² Eckert Direct Testimony, p. 8.

¹¹³ Eckert Direct Testimony, p. 7.

¹¹⁴ Ms. Eckert asserts that benchmarking intrastate rates to the FCC (interstate) rates does not reduce arbitrage problems. The problem she is alluding to, however, as her subsequent discovery response makes clear, is that for some rural LECs the interstate rate is still so excessive that reducing intrastate rates to that level will not eliminate call pumping or certain other types of arbitrage activities. See, Qwest's Responses to AT&T Data Request 5-001. This may be true, but is not a problem this Commission can solve. Nor would Qwest's proposal better address it than AT&T's: regardless of the level to which a LEC's intrastate rate is reduced, any call pumping incentives created by excessive interstate rates will remain. AT&T's proposal will eliminate the incentive for traffic-shifting arbitrage between interstate and intrastate, even where the FCC rate is excessive. Qwest's proposal will not.

1 Q: MS. ECKERT ASSERTS THAT "MANY STATES HAVE FOLLOWED THIS
2 APPROACH" OF SETTING THE LECS' INTRASTATE RATES EQUAL TO
3 THE INTRASTATE RATE OF THE LARGEST ILEC IN THE STATE.¹¹⁵
4 PLEASE COMMENT.

5 A: States that have most recently implemented switched access reform have required CLECs
6 to mirror ILECs' intrastate rates, *but the ILECs are, in turn, required to mirror their*
7 *intrastate rates to their interstate rates.* In Massachusetts, as of an order issued last year,
8 CLECs are required to target their access rates to the intrastate rate of the largest ILEC in
9 the state, as Qwest proposes here.¹¹⁶ However, the largest ILEC, Verizon, is also required
10 to mirror its intrastate switched access rates to its interstate levels, so the cap effectively
11 sets CLEC rates *at the ILEC's interstate level*, not a higher intrastate level.¹¹⁷

12 Similarly, in New Jersey, the Board of Public Utilities recently ordered CLEC rates to be
13 capped at the intrastate rate of the ILEC with which it competes; and it also caps all
14 ILECs' intrastate rates at their interstate levels, the same proposal AT&T is making
15 here.¹¹⁸

¹¹⁵ Eckert Direct Testimony, p. 8.

¹¹⁶ 2009 Massachusetts Order, p. 30.

¹¹⁷ 2009 Massachusetts Order, p. 6. CLECs are permitted to exceed the cap only if they make a showing to the Commission that their costs exceed the rate cap. See, 2009 Massachusetts Order, p. 27. According to the CLECs' discovery responses in this case, none of them has ever made a cost showing to a state commission that resulted in the CLEC being able to charge rates above the cap.

¹¹⁸ New Jersey 2010 Order, pp. 28-29. Unlike AT&T's proposal here, New Jersey ordered that the rate reductions be phased in over 3 years.

1 Other states that have required CLECs to cap their intrastate access rates at ILECs' rates
2 are Ohio and Texas, where the CLECs' intrastate rates are capped at the intrastate rates of
3 the competing ILECs', and the ILECs' rates are, again, capped at the interstate level.¹¹⁹

4 **Q: IS IT REASONABLE FOR QWEST TO NOT HAVE TO REDUCE ITS**
5 **INTRASTATE ACCESS RATE ON THE GROUNDS THAT IT HAS ALREADY**
6 **REDUCED ITS RATES TO SOME EXTENT OVER THE LAST SEVERAL**
7 **YEARS?**¹²⁰

8 **A:** No. Although Qwest's intrastate access rates were decreased in Arizona on a number of
9 occasions in the last eight years, its intrastate rates remain well above the interstate rates
10 to which Qwest agreed in the interstate jurisdiction and that it has been charging for eight
11 years. In fact, Qwest's intrastate access rates in Arizona remain not only well above its
12 interstate rates ordered by the FCC, they are among the highest intrastate access rates
13 permitted for RBOCs *in the nation*. Specifically, looking at the major RBOCs across 48
14 US states,¹²¹ Qwest's intrastate access rates in Arizona are higher than the RBOCs'
15 intrastate access rates in all but nine states. Among the states in which Qwest is the
16 RBOC, Qwest's average intrastate rates in Arizona are sixth highest out of fourteen
17 states.

¹¹⁹ In Illinois there is not a generalized policy for CLECs but the Illinois Commerce Commission's decisions on individual CLECs have effectively capped their rates at the ILEC's interstate level. Some other states, including Maine and New Mexico, cap CLECs' intrastate switched access rates directly at their own interstate levels (which, again, are constrained by the FCC). See, *Aron Direct Testimony*, pp. 52-54.

¹²⁰ *Eckert Direct Testimony*, pp. 3, 5.

¹²¹ I was unable to collect intrastate rate information for Alaska and Hawaii for this comparison.

1 Q: PLEASE COMMENT ON MS. ECKERT'S CONTENTION THAT
2 AGREEMENTS BETWEEN IXCS AND CLECS ARE PROBATIVE THAT
3 QWEST'S RATE IS A REASONABLE TARGET RATE FOR OTHER
4 CARRIERS.¹²²

5 A: I do not have access to the agreements so I cannot test the assertion that "a majority" of
6 these agreements "benchmark to the ILEC rates;" nor whether the "ILEC rates" alluded to
7 by Ms. Eckert are the rates of the ILEC with whom the CLEC competes or are Qwest's
8 rates; nor whether the "ILEC rates" alluded to are tariffed interstate rates, tariffed
9 intrastate rates, or something else. Whatever they are, however, the agreed-upon rates
10 reflect the outcome of negotiations between IXCs with limited recourse and CLECs with
11 market power over switched access. Therefore, the only inference one can draw is that
12 the agreed-upon price is above the CLEC's costs of providing service and lower than
13 what the IXC would have to pay without the agreement. How much above the CLECs'
14 cost the price is cannot be determined by reference to the fact that the prices were agreed
15 to. Hence, there is no reason to consider the negotiated rates for switched access a
16 reasonable target as compared to the ILEC's interstate rates.

¹²² Eckert Direct Testimony, pp. 7, 11-12.

1 **VI. Response to the Direct Testimony of Don Price on Behalf of Verizon**

2 **Q: VERIZON PROPOSES THAT QWEST'S INTRASTATE RATE BE USED AS**
3 **THE TARGET LEVEL FOR INTRASTATE ACCESS RATES.¹²³ WHAT**
4 **ARGUMENTS DOES MR. PRICE OFFER IN SUPPORT OF THIS PROPOSAL?**

5 **A:** In addition to the same arguments posited by Qwest, to which I have already responded,
6 Mr. Price argues that Qwest's rates are the "prevailing market rate,"¹²⁴ and that Qwest's
7 rates "have historically been subject to the most regulatory scrutiny."¹²⁵

8 **Q: HAVE QWEST'S INTRASTATE RATE BEEN SUBJECT TO MORE**
9 **REGULATORY SCRUTINY THAN ITS INTERSTATE RATE?**

10 **A:** No. In fact, the ILECs' interstate rates were determined on the basis of an extensive,
11 multi-year, multi-party proceeding in which comments were provided by ILECs, CLECs,
12 state commissions, congressmen, consumer advocate groups, industry trade groups,
13 attorneys general, and others that culminated in the FCC's adoption of the rates that are in
14 effect today. The FCC found, in full recognition of the regulatory history and public
15 policy role that carrier switched access rates have historically played, the rates it adopted
16 to be beneficial to consumers, pro-competitive, and economically efficient.¹²⁶ In
17 addition, the *CALLS Order* permitted ILECs that did not wish to adopt the ordered rates

¹²³ *Price Direct Testimony*, p. 3. Mr. Price points that if the Commission declines to impose a single rate, then it should require CLECs to benchmark their rates at the competing ILEC's intrastate rates. See *Price Direct Testimony*, pp. 10-12.

¹²⁴ *Price Direct Testimony*, p. 13.

¹²⁵ *Price Direct Testimony*, pp. 15, 19.

1 to seek separate consideration by filing their own cost studies for consideration by the
2 FCC.¹²⁷ In fact, neither Qwest nor Verizon filed cost studies for special consideration by
3 the FCC, but chose to adopt the FCC's ordered interstate rates.¹²⁸

4 **Q: IS QWEST'S INTRASTATE RATE THE "PREVAILING RATE" IN**
5 **ARIZONA?**¹²⁹

6 **A:** No. If by "prevailing rate," Verizon means the rate most frequently charged, Qwest's
7 intrastate rate is certainly not the prevailing intrastate rate in Frontier's or Verizon's
8 territory in Arizona, since Qwest's intrastate rate is not charged there at all. In fact it is
9 also not the prevailing access rate in Qwest's own territory. The prevailing rate in its own
10 territory for switched access service is its *interstate rate*. Qwest sells about five times
11 more interstate access minutes than intrastate access minutes.¹³⁰ Hence, if anything,
12 Qwest's "prevailing rate" for originating and terminating functionality is its average
13 interstate access rate.

¹²⁶ FCC CALLS Order, ¶ 29.

¹²⁷ FCC CALLS Order, ¶ 57.

¹²⁸ I am aware of only one ILEC that sought forbearance from the CALLS Order rates, a small rural ILEC in Iowa that submitted a cost study to the FCC. See, Order, *In the Matter of Petition for Forbearance of Iowa Telecommunications Services, Inc. d/b/a/ Iowa Telecom Pursuant to 47 U.S.C. § 160(c) from the Deadline for Price Cap Carriers to Elect Interstate Access Rates Based on the CALLS Order or a Forward Looking Cost Study*, Before the Federal Communications Commission, CC Docket No. 01-331, FCC 02-323, (released November 26, 2002); and Order on Reconsideration, *In the Matter of July 1, 2003 Annual Access Charge Tariff Filings*, Before the Federal Communications Commission, WCB/Pricing No. 03-15, FCC 03-295, (released November 17, 2003).

¹²⁹ Price Direct Testimony, p. 13.

¹³⁰ Qwest's Response to Staff Data Request 1.1.

1 **VII. Response to the Direct Testimony of Dr. Ben Johnson on Behalf of RUCO**

2 **Q: DO YOU HAVE ANY GENERAL COMMENTS ABOUT DR. JOHNSON'S**
3 **TESTIMONY?**

4 **A:** Yes. Unfortunately, Dr. Johnson has entirely ignored all of the testimony that was filed in
5 this case weeks before his testimony was due; other than acknowledging its existence at
6 the beginning of his testimony, he does not mention any of it even once. He raises issues
7 that were examined in parties' testimonies without acknowledging the facts or issues
8 already presented, and therefore his testimony is essentially disengaged from the current
9 state of the debate in this case. This disengagement is compounded by the fact that his
10 testimony is largely rooted in the issues and concerns of the telecommunications
11 marketplace of a decade ago or more. He has declined to seriously grapple with the
12 realities and facts of the current state of affairs in the market, such as the impact of the
13 ubiquity of wireless telephony and the growth of VoIP on concerns about overall
14 telephone penetration, a central topic of his testimony. Nevertheless, because he does not
15 make any clear policy recommendations and because much of his testimony does not
16 appear to me to lead to discernible policy recommendations, I will not respond to most of
17 his testimony but will focus on just a few key points and issues. My very limited
18 response should not be interpreted as agreement with any of Dr. Johnson's remarks about
19 which I have not commented.

1 **Q: WHAT IS HIS MAIN POINT?**

2 A: I believe that what Dr. Johnson is saying in his testimony is that the Commission is
3 charged with pursuing possibly conflicting policy goals of equity, efficiency, and
4 universal service, and that by reducing switched access rates the Commission must take
5 due care to recognize that increasing local exchange rates by a corresponding amount
6 could jeopardize goals of universal service.¹³¹ It appears that one of his main points is to
7 urge the Commission to "carefully think through the consequences of any future
8 reduction or elimination in intrastate access charges, and develop a plan which will help
9 minimize the adverse consequences of any such changes."¹³²

10 **Q: WHAT ARE THE ADVERSE CONSEQUENCES TO WHICH HE REFERS?**

11 A: Dr. Johnson appears to be concerned about the possible effect of retail price increases on
12 telephone penetration.

13 **Q: IS THAT A VALID CONCERN?**

14 A: I addressed this concern in my Direct Testimony. I explained that while the potential
15 effects of retail price increases on overall telephone penetration is certainly an issue that
16 regulators must attend to, the evidence suggests that at least some increase in retail rates

¹³¹ See, for example, *Johnson Direct Testimony*, p. 24.

¹³² *Johnson Direct Testimony*, p. 48.

1 is tolerable.¹³³ Dr. Johnson's testimony fails entirely to recognize that 97 percent of the
2 population in Arizona over the age of 15 has a wireless phone,¹³⁴ and that the wireless,
3 wireline, and VoIP networks are interconnected; and fails to appreciate the implications
4 of these 21st century realities for universal service. As I discussed in my Direct
5 Testimony, even if increasing retail wireline prices caused some customers to drop their
6 wireline telephone service, this would not necessarily have any effect at all on universal
7 service or telephone penetration if those customers choose to rely on other technologies to
8 meet their communications needs.¹³⁵ Only to the extent that price increases cause
9 customers to drop their wireline phone and to not subscribe instead to cable telephony,
10 wireless, or some other form of telephony, would retail rate increases possibly impact
11 goals of universal service.

12 Nevertheless, it is certainly reasonable to advise the Commission to "think through the
13 consequences" of reducing access rates and develop a plan to minimize any potential
14 adverse consequences. This is precisely what AT&T did in Dr. Oyefusi's Direct
15 Testimony, wherein Dr. Oyefusi proposed a number of options for implementing access
16 reform that would ease any burden on consumers.

¹³³ Aron Direct Testimony, pp. 93-99.

¹³⁴ "Local Telephone Competition: Status as of June 30, 2008," Federal Communications Commission, Industry Analysis and Technology Division, Wireline Competition Bureau, July 2009, Table 14; and US Census Bureau, "2008 American Community Survey, Selected Population Profile in the United States - Arizona."

¹³⁵ Aron Direct Testimony, pp. 93-95.

1 **Q: PLEASE EXPLAIN.**

2 **A:** In response to possible concerns that immediate retail rate increases that would
3 compensate ILECs for forgone access revenues would cause rate shock or declines in
4 telephone penetration, AT&T proposed to reduce intrastate access rates to interstate rates
5 immediately, but phase in price increases over time to replace that revenue by setting a
6 maximum annual price increase. The forgone revenue that is not recovered through the
7 annual increase would be replaced with AUSF funds in the short run, but the AUSF
8 support would be decreased and the retail price would be increased until it reaches an
9 established benchmark over a measured period of time (for example, two years) to
10 minimize rate shock.¹³⁶ Such a plan would provide Arizona long distance customers with
11 the benefits from reduced access rates immediately, would reduce incentives for arbitrage,
12 and would decrease the distortions to intermodal long distance competition, while
13 phasing in the necessary retail rate increases over time and to a level that the Commission
14 considers acceptable and consistent with universal service goals. This plan meets Dr.
15 Johnson's objectives of increasing efficiency (by decreasing access rates right away)
16 while moving slowly and deliberately on retail price increases that he believes could
17 reduce telephone penetration.

¹³⁶ See, Direct Testimony of Dr. Ola Oyefusi on Behalf of AT&T Communications of the Mountain States, Inc. and TCG Phoenix, *In the Matter of the Review and Possible Revision of Arizona Universal Service Fund Rules, Article 12 of the Arizona Administrative Code and In the Matter of the Investigation of the Cost of*

1 Q: DID DR. JOHNSON RESPOND TO OR COMMENT ON THESE PROPOSALS?

2 A: No. He did not acknowledge them.

3 Q: IS DR. JOHNSON CORRECT IN HIS SUGGESTION THAT AT&T IS
4 PROPOSING TO BE ABLE TO USE LECS' NETWORKS "WITHOUT PAYING
5 ANYTHING FOR THIS PRIVILEGE,"¹³⁷ OR ASKING FOR A "FREE RIDE"?¹³⁸

6 A: No. AT&T is proposing to pay rates that by all evidence exceed the ILECs' costs of
7 providing switched access service to AT&T. Dr. Johnson is simply incorrect and out of
8 step with economic thinking to suggest that IXCs would get a "free ride" if they do not
9 contribute to the cost of building a loop, as I explained at length earlier. The cost
10 associated with switched access is the cost of switching and associated transport, not the
11 cost of the loop.

12 Q: PLEASE COMMENT ON DR. JOHNSON'S VIEW THAT "THE COMMISSION
13 SHOULD PLACE A VERY HIGH BURDEN OF PROOF ON PARTIES THAT
14 ARE URGING EXTREME CHANGES TO COST RECOVERY PATTERNS
15 WHICH HAVE PROVEN SO SUCCESSFUL FOR SO MANY YEARS."¹³⁹

16 A: It is astonishing that Dr. Johnson could have read ALECA's testimony (not to mention
17 that of AT&T or Sprint) and continue to believe that the current system of cost recovery
18 that requires rural ILECs to rely on the crumbling and antiquated system of excessive

Telecommunications Access, Before the Arizona Corporation Commission, Docket Nos. RT-00000H-97-0137 and T-00000D-00-0672, December 1, 2009, pp. 63-68.

¹³⁷ *Johnson Direct Testimony*, p. 9.

¹³⁸ *Johnson Direct Testimony*, p. 17.

¹³⁹ *Johnson Direct Testimony*, p. 37.

1 access rates is "so successful." In fact, even aside from the harms to competition and
2 efficiency that I have discussed, the current system of access rates is *not* successful any
3 longer even for its original purpose of subsidizing local exchange companies. It is no
4 longer successful because, as I have explained and as ALECA has made clear in its
5 testimony and white paper, access revenues are no longer a reliable source of subsidy.
6 They create a self-reinforcing downward spiral of support for LECs because high access
7 rates force wireline long distance rates up, which makes wireline long distance service
8 less competitive relative to wireless and other technologies that do not pay access rates to
9 the same extent as do wireline IXC's, or do not pay them at all; customers migrate from
10 wireline to other forms of long distance communication; and access revenues dry up for
11 the LECs that they historically supported.

12 I would also note that, as I just explained, AT&T is not proposing any policy reform that
13 would necessarily confront consumers with "extreme" changes, because AT&T's
14 proposal includes options that would bring changes to wireline local exchange
15 consumers' prices at a phased-in pace determined by the Commission.

1 Q: ACCORDING TO DR. JOHNSON, "WHILE REDUCING ACCESS RATES MAY
2 BENEFIT SOME CARRIERS, THE POLICY CHANGES BEING ADVOCATED
3 IN THIS CASE WON'T NECESSARILY HELP NEW ENTRANTS GAIN A
4 FOOTHOLD IN THE MARKET."¹⁴⁰ PLEASE COMMENT.

5 A: "Helping new entrants gain a foothold in the market" is not a valid or responsible public
6 policy goal. Helping new entrants gain a foothold in the market means subsidizing them,
7 protecting them from competition, applying rules unequally to them, or otherwise
8 enhancing their ability to succeed beyond what the quality and costs of their own business
9 can accomplish. Such market intervention is harmful to competition and harmful to
10 consumers. This is a classic flaw associated with what is known as the "infant industry"
11 argument.

12 Often implemented in the form of tariffs to protect a fledgling domestic industry from
13 foreign competition, the "infant industry" rationale encourages policy makers temporarily
14 to handicap incumbents or offer preferences to their less-experienced rivals in order to
15 boost the latter's ability to compete and overcome the alleged advantages of incumbency.
16 There are many pitfalls associated with infant industry regulations, which cause
17 economists, as a whole, to question their wisdom in most circumstances.¹⁴¹

¹⁴⁰ Johnson Direct Testimony, p. 25.

¹⁴¹ Alfred E. Kahn and William E. Taylor, "The Pricing of Inputs Sold to Competitors: A Comment," *Yale Journal on Regulation* 11 (Winter 1994), pp. 225-240.

1 In general, it is very difficult to eliminate the preferential treatment once the entrants are
2 on their feet. Establishing undue regulatory protections of any sort encourages firms to
3 enter, make sunk investments, and thereby become reliant on the regulatory protections
4 under which their investments made economic sense. Some such providers may not be
5 viable at all without protection, and others may have made investments that would have
6 been excessive or unwise had the protection not been in place. Once the entrants are in
7 the market and investments are made, however, these parties become a visible political
8 factor and it may become difficult to abandon the protections that render them viable.
9 Indeed, we see this very phenomenon in this case, in which competitors who have
10 benefited from the opportunity to charge excessive access rates now appeal to the
11 regulator to perpetuate that policy in order to protect their business models.

12 In addition, any regulation that protects a class of competitors from competition imposes
13 a cost stemming from its interference with the efficient distribution of supply among
14 competitors on the basis of their relative costs. Competition is facilitated, efficiency
15 promoted, and consumers benefited when regulators establish conditions under which
16 efficient competitors will survive and inefficient competitors will either improve or exit.
17 As the CLECs themselves admitted in discovery when asked what alterations they would

1 have to make to their business plans if access rates were lowered to Qwest's interstate
2 level, "CLECs would have to look for ways to offset reduced revenue or cut their cost."¹⁴²

3 In any event, if the Commission did choose to intervene in the market by "helping" new
4 entrants "gain a foothold" in the market, there is no policy or economic justification for
5 doing so by requiring wireline IXCs and their customers to provide the subsidy. Such a
6 subsidy policy should be borne by all consumers and should be exposed to the court of
7 public opinion by being funded through explicit means. Finally, providing a subsidy to
8 "new entrants" through excessive intrastate access rates would equally provide a subsidy
9 to competitive firms such as the Joint CLECs and Cox, who are hardly "new," have been
10 operating in Arizona for at least eight years, and (in the case of XO and tw telecom) are
11 multinational corporations.

12 **VIII. Response to the Direct Testimony of Wilfred Shand on Behalf of Staff**

13 **Q: DO YOU HAVE ANY OVERALL COMMENTS ON STAFF'S TESTIMONY?**

14 **A:** Yes. Staff correctly articulates four benefits of access reform:¹⁴³

- 15 1. Price efficiency
16 2. Reduction of arbitrage opportunities

¹⁴² Joint CLECs' Response to AT&T Data Request ATT 1-3, response subject to the objection that the term "business plan" is "vague and ambiguous."

¹⁴³ *Shand Direct Testimony*, p. 9.

- 1 3. Elimination of differences in rates that occur because of regulatory decisions
- 2 4. Establishment of more consistent and rational intrastate switched access rates.

3 However, like Qwest and ALECA, Staff's proposed reform would not achieve the
4 benefits it has identified. Staff proposes that ALECA members and the CLECs be
5 required to reduce their rates to Qwest's intrastate level.¹⁴⁴ Staff proposes to exempt
6 Qwest from any rate reductions.¹⁴⁵ I explained in my response to Ms. Eckert and Mr.
7 Meredith why such a proposal is inadequate to address the policy goals that are listed
8 above.

9 **Q: WHAT IS STAFF'S RATIONALE FOR EXCLUDING QWEST FROM ACCESS**
10 **RATE REDUCTIONS?**

11 A: Staff's only rationale appears to be that Qwest has already made access rate reductions.¹⁴⁶

12 **Q: IS THAT A GOOD REASON TO EXCLUDE QWEST FROM ACCESS REFORM**
13 **IN THIS CASE?**

14 A: No. As I have already discussed, although Qwest has made some progress, that does not
15 mean that the Commission should stop moving forward or that Qwest's current intrastate
16 switched access rates are just and reasonable for consumers. Qwest's intrastate switched
17 access rates are still well above its corresponding interstate rates. As I have explained,
18 the Commission's objective in this case should not be to protect some carriers or to

¹⁴⁴ *Shand Direct Testimony*, pp. 2, 11.

¹⁴⁵ *Shand Direct Testimony*, p. 3.

1 balance carriers' interests. It should be to advance consumer welfare by promoting a
2 more efficient rate structure and thereby facilitating competition on the merits. As the
3 largest carrier in Arizona, Qwest's rates have the greatest influence on average intrastate
4 access prices borne by IXC's and, in turn, their customers. There is no sound public
5 policy reason to protect Qwest's access revenue flow by preserving excessive rates at the
6 expense of Arizona customers and in contravention of sound policy principles.

7 **Q: STAFF ALSO PROPOSES THAT IXCS BE REQUIRED TO MAKE A FILING**
8 **WITH THE COMMISSION TO DEMONSTRATE THAT THEY HAVE PASSED**
9 **THROUGH ACCESS RATE REDUCTIONS.¹⁴⁷ PLEASE COMMENT.**

10 **A:** I would caution the Commission that there are a number of practical impediments to
11 actually enforcing such a requirement, at least if what Staff means is that AT&T would be
12 required to demonstrate 100% (or any other specific level of) pass-through. These
13 impediments would make enforcement resource-intensive, for a requirement that is not
14 necessary. The evidence shows that market mechanisms will result in a significant degree
15 of flow-through in any event.

16 Any carrier's retail rate structure consists of multiple rate plans, including discount plans
17 that may be available only for a defined period of time; recurring and non-recurring rates;
18 and new and discontinued rate plans. In addition, a carrier's access expense is a

¹⁴⁶ *Shand Direct Testimony*, p. 3.

¹⁴⁷ *Shand Direct Testimony*, p. 13.

1 combination of the rates charged by each LEC, the particular combination depending on
2 the number of access minutes purchased from each LEC. If some or all LECs reduce
3 their access rates, the amount by which IXCs' access expenses decline in total and on a
4 per-minute basis will vary from one IXC to another, and from one time period to another.

5 With respect to the retail rates, a rational IXC will respond to a reduction in access rates
6 by reducing retail prices, but how it reduces its retail prices could take many forms. For
7 example, it could offer discounts on existing plans; it could focus greater resources on
8 encouraging new customers to purchase existing discounted rate plans; it could focus
9 greater resources on encouraging customers to switch from existing higher-priced to
10 lower-priced rate plans; it could introduce new rate plans while keeping the old ones; it
11 could grandfather certain higher-priced existing rate plans while not introducing new
12 plans; it could reduce volume-sensitive (per minute) rates on existing plans; it could
13 reduce non-volume-sensitive rates on existing plans; it could increase the number of
14 minutes offered for a given flat price; it could expand the times of day in which lower
15 rates apply; or any number of other possibilities. Any or all of these rate changes would
16 decrease the average price paid by customers for long distance services. I would expect
17 an IXC to attempt to monitor the pricing changes of its competitors and to engage in a
18 certain amount of market research and trial and error to determine which kinds of rate
19 plan changes would be most effective at profitably attracting more customers in response

1 to its lower costs. Like any rate change the effects on customers' demand and usage, and
2 therefore the effect on average and total retail revenues, would be uncertain for the IXC
3 and variable over time.

4 The "access rate reduction" for each IXC resulting from an ordered reduction in access
5 rates would have to be computed as the difference between an average rate paid by that
6 IXC over a specified period of time before the rate change, and an average rate paid (or
7 total access expense) by that IXC over a specified period after the rate change. These
8 calculations will be sensitive to the time period chosen for analysis, as well as exogenous
9 factors outside the control of the IXC, such as consumer switching between wireline local
10 and wireless service, VoIP, and other services, and overall economic conditions. That is,
11 some (generally unpredictable) component of the measured change in total and average
12 access expenses will be the result of factors other than the change in access rates.

13 The actual average "retail rate reduction" associated with reductions to access rate
14 elements would similarly have to be computed as the difference between an average paid
15 by consumers to that IXC over some period of time before the access rate reduction and
16 an average paid by consumers to the IXC over some period of time after the access rate
17 reduction. Alternatively, the reduction could be computed as total revenue reduction
18 rather than on a per-minute basis. In either case the reduction will depend on the time

1 period chosen and factors such as secular declines in wireline long distance demand,
2 population growth, and economic conditions.

3 Quantifying the amount by which actual access rate reductions were "passed through" in
4 Arizona in order to assess whether the pass through meets a given standard would
5 therefore require comparing the measured reduction in average (or total) access rates paid
6 with the measured reduction in average revenues, and attempting to control for exogenous
7 factors. My point is not that this is necessarily impossible, but that such an analysis
8 would be very resource intensive and costly, and achieving results with high degrees of
9 confidence may in fact be impossible.¹⁴⁸ It is not a mechanical exercise, and determining
10 whether the pass through actually achieved by a given carrier in a single state was really
11 100% or any other specific level would require data and control variables that may or may
12 not be available. In fact, when asked in discovery whether they have passed through
13 access rate reductions in the states in which they provide long distance service, the
14 CLECs responded that they did not know and such a determination would require an
15 "extensive special study."¹⁴⁹

¹⁴⁸ This exercise is significantly more challenging than testing whether decreased access rates cause retail rates to fall on average, as I did, because the latter can be tested by looking at the relationship between retail prices and access rates across all states and multiple time periods.

¹⁴⁹ Joint CLECs' Responses to AT&T Data Requests ATT 1-10 and ATT 1-11.

1 Such an analysis is not needed for the Commission to protect consumers' interests in
2 Arizona. As I explained in my Direct Testimony, IXC's have both a profit incentive and a
3 competitive impetus to decrease retail prices in response to reduced access rates, and the
4 data are persuasive that they in fact do so.

5 **Q: STAFF CLAIMS THAT INTERSTATE ACCESS CHARGES ARE LOWER**
6 **THAN INTRASTATE RATES BECAUSE THE FCC INSTITUTED THE SLC,**
7 **FOR WHICH THERE IS NO INTRASTATE EQUIVALENT.¹⁵⁰ IS THAT**
8 **CORRECT?**

9 **A:** No. The equivalents to the SLC (the Subscriber Line Charge) in the intrastate arena are
10 local exchange prices themselves. The logic of creating the SLC was so that cost
11 recovery would more closely follow cost-causation, which means that the cost of the loop
12 should be recovered through flat-rated (not usage sensitive) charges imposed on
13 customers (not IXC's). The direct way to accomplish this is to increase retail prices to
14 customers for local exchange access. Unlike the Commission, however, the FCC does
15 not have the authority or jurisdiction over local exchange prices to do so. Hence, the
16 FCC adopted its next-best alternative, which was largely to permit the revenue reductions
17 from reduced interstate traffic-sensitive access rates to be recovered in fixed (non-traffic-
18 sensitive) fees (the SLC) that are charged to subscribers, not to carriers.

¹⁵⁰ *Shand Direct Testimony*, p. 4.

1 In fact, the FCC has been very clear that its objective throughout the last 25 years of
2 access rate reform has been to reduce the subsidy burden on IXC's, and to modify the
3 interstate access rate structure so that it more closely follows cost causation and recovers
4 the costs of local service from local service subscribers. In implementing the interstate
5 access regime in 1983, the FCC concluded as follows:

6 The driving force behind our decision to move toward flat [charges] is our
7 commitment to promoting efficient use of the nationwide
8 telecommunications network and our recognition that pricing reform is
9 necessary to enable our society to maximize its efficient use of the
10 telecommunications network and realize the benefits possible from
11 increasing competition in the interexchange marketplace. Artificial
12 pricing structures, while perhaps appropriate for use in achieving social
13 objectives under the right conditions, cannot withstand the pressures of a
14 competitive marketplace. We see the imposition of moderate flat charges
15 on telephone subscribers as an effective, orderly and fair means of guiding
16 telecommunications pricing in the direction which it inevitably must take,
17 toward efficient, cost-based rates. The concept that users of the local
18 telephone network should be responsible for the costs they actually cause
19 is sound from a public policy perspective and rings of fundamental
20 fairness. It assures that ratepayers will be able to make rational choices in
21 their use of telephone service, and it allows the burgeoning
22 telecommunications industry to develop in a way that best serves the needs
23 of the country.¹⁵¹

24 Over a decade later, in its *Access Charge Reform Order* (1997), the FCC again clearly
25 articulated its objective to adhere to cost-causation principles as follows:

¹⁵¹ Memorandum Opinion and Order, *In the Matter of MTS and WATS Market Structure*, Before the Federal Communications Commission, CC Docket No. 78-72, Phase I, FCC 83-356, (released August 22, 1983), 97 F.C.C.2d 682 at ¶ 7.

1 The Commission has recognized in prior rulemaking proceedings that, to
2 the extent possible, costs of interstate access should be recovered in the
3 same way that they are incurred, consistent with principles of cost-
4 causation. Thus, the cost of traffic-sensitive access services should be
5 recovered through corresponding per-minute access rates. Similarly, NTS
6 [non-traffic sensitive] costs should be recovered through fixed, flat-rated
7 fees.¹⁵²

8 The FCC's approach to rate reform has therefore been to modify interstate rates so that
9 the costs of local exchange service are recovered from local exchange subscribers using
10 the pricing tools it had available. The Commission can achieve the same objective by
11 replacing subsidies embedded in intrastate traffic-sensitive carrier access rates with the
12 opportunity to recover costs via increased retail prices for local services.

13
14 **Q: DOES THIS COMPLETE YOUR REPLY TESTIMONY?**

15 **A: Yes.**

¹⁵² First Report and Order, *In the Matter of Access Charge Reform and Price Cap Performance Review for Local Exchange Carriers et al.*, Before the Federal Communications Commission, CC Docket Nos. 96-262 and 94-1 et al., FCC 97-158, (released May 16, 1997), ¶ 24.

Arizona Docket Nos. RT-00000H-97-0137 and T-00000D-00-0672
Joint CLEC
Request No. 1
DR.6

Question: In Docket WC Docket No. 06-147, Petition of the Embarq Local Operating Companies for Forbearance Under 47 U.S.C. § 160(c) from Application of Computer Inquiry and Certain Title II Common-Carriage Requirements, the FCC noted with respect to enterprise customers:

We also observe the sophistication of the enterprise customers that tend to purchase broadband telecommunications services. The Commission consistently has recognized that customers that use specialized services, similar to the petitioner-specified services, demand the most flexible service offerings possible, and that service providers treat them differently from other types of customers, both in the way they market their products and in the prices they charge. These users tend to make their decisions about communications services by using either communications consultants or employing in-house communications experts. This shows that customers are likely to make informed choices based on expert advice about service offerings and prices, and thus suggests that these users also are likely to be aware of the choices available to them. The Commission has further found that the *large revenues* these customers generate, and their need for reliable service and dedicated equipment, provide a significant *incentive to suppliers to build their own facilities* where possible, and to carry the traffic of these customers over the suppliers' own networks. (Paragraph 23.) (Emphasis added.) Para 24. Even in situations where competitors do not have the option of self-deploying their own facilities or purchasing inputs from carriers other than the incumbent LEC, potential providers may rely on *special access services* purchased from the incumbent LEC at rates subject to price regulation. (Paragraph 24) With respect to this statement, please answer the following questions:

- a. Does Dr. Aron agree with the FCC's assessment that "the large revenues these customers generate, and their need for reliable service and dedicated equipment, provide a significant *incentive to suppliers to build their own facilities* where possible, and to carry the traffic of these customers over the suppliers' own networks." Further, please explain the extent to which the same can be said where it concerns originating switched access services to enterprise customers? To the extent that Dr. Aron believes that suppliers do not have incentives to build their own facilities to serve such enterprise customers, please (a) explain why that is so, and (b) do suppliers never have such incentives, no matter how large the enterprise customers or does it depend on the size of the customer (please explain.)?
- b. Please admit or deny that In New Jersey Docket No. TX08090830, Dr. Aron testified that special access services can be used to accommodate access traffic and are a competitive alternative to switched access services. To the

extent that Dr. Aron denies the statement, please discuss the extent to which she does believe that special access services and switched access services are competitive alternatives for (i) originating traffic, and (ii) terminating traffic.

- c. Please discuss the extent to which Dr. Aron believes that self-provisioning of facilities offer an alternative to the CLECs' access facilities for (i) originating traffic, and (ii) terminating traffic.

Response:

- a. AT&T objects to this question on the grounds that it is irrelevant to this proceeding and not reasonably calculated to lead to the discovery of admissible evidence. Without waiving that objection, AT&T responds as follows:

It is not clear whether the question refers to special access dedicated facilities or switched dedicated facilities (e.g., direct trunking facilities). AT&T assumes the question implies the former, and the answer is "yes." With respect to originating switched access to enterprise customers, for any given customer for whom the cost of building facilities to that customer is K , and for any level of switched access cost r charged by the LEC serving that customer, there will generally exist some finite level of originating access minutes $N^*(r)$ such that if that customer's originating access minutes of use exceeded $N^*(r)$ it would be optimal for a supplier to build a dedicated facility to that customer to bypass the switched access. However, this case is about reform of switched access charges levied for calls to customers whose traffic volumes are less than $N^*(r)$ and for whom it would therefore not be economical to build a special access facility. Since the CLECs' switched access rates will not apply to the special access or dedicated facilities being referenced, and because the availability of special access for customers whose traffic volumes justify special access will not and does not adequately discipline prices for switched access services (see response to part (c) below) this question is irrelevant to this proceeding.

- b. In New Jersey Dr. Aron's prefiled written testimony did not address special access. Her oral testimony addressing special access consisted in its entirety as follows:

Cross Examination by Eric Krathwohl, counsel for the 9 Joint CLECs of New Jersey:

MR. KRATHWOHL:

2 Q Good afternoon, Doctor.

3 A Good afternoon, sir.

4 Q Is it correct that AT&T provides switched
5 access services?

6 A AT&T, the company, the parent company, AT&T New
7 Jersey?

8 Q Let's start with AT&T New Jersey?

9 A AT&T, the broader company, does.

10 I don't know about the various corporate
11 entities.

12 Q And whichever entity does provide switched
13 access services, would you say that it has market
14 power with respect to such provision of services?

15 A Yes.

16 Q Would you agree that switched access and
17 special access services are sometimes substituted?

18 A In some cases they are for certain types of
19 large business customers.

See, Hearing Transcripts, before the State of New Jersey Board of Public Utilities,
Docket No. TX08090830, September 15, 2009, p. 142.

- c. Self-provisioning of facilities provides an alternative to CLECs' access service as described in (a) and articulated in (b). This alternative will not discipline the LEC's access rates to a cost based level, however. To see this, let $f(N)$ be the frequency distribution of LEC i's customers as a function of the access usage N of each customer. (I will treat $f(\cdot)$ as continuous but this is without loss of generality). Let $k \geq 0$ be the per minute cost of providing switched access. Then i's profits from switched access are

$$\pi = \int_{N_0}^{N^*(r)} (r - k) N f(N) dN,$$

where N_0 is the access usage level of the customer(s) served by LEC i that has (have) the lowest access usage, and $N^*(r)$ is as defined in (a). Maximizing profit with respect to r yields the first order condition

$$\int_{N_0}^{N^*(r^*)} N f(N) dN + (r^* - k) N^*(r^*) f(N^*(r^*)) \frac{dN^*(r^*)}{dr} = 0.$$

$N^*(r)$ satisfies the condition $\frac{K}{N^*(r)} \equiv r$ for all r . Hence, $\frac{dN^*(r^*)}{dr} < 0$.

Therefore, r^* strictly exceeds k as long as N_0 is strictly less than $N^*(r^*)$. But a rational LEC would not choose $N_0 = N^*(r^*)$ because it would ensure zero profits while $N_0 < N^*(r^*)$ will ensure positive profits.

Responsible Person: Dr. Aron

Table 1

CLEC Statements Regarding Regulation of Access Rates

Date	Filing	Company	Statement
Mar-98	1997 10K	McLeodUSA	[Interstate] access rates make up a significant portion of the cost of providing long distance service. The FCC has recently implemented changes to its interstate access rules that result in restructuring of the access charge system and changes in access charge rate levels. These changes reduce per-minute access charges and substitute new per-line flat-rate monthly charges. These actions, along with additional changes which may occur later this year and in subsequent years, may reduce access rates, and hence the cost of providing long distance service, especially to business customers. However, the impact of the FCC's new decisions will not be known until those decisions are fully implemented over the next several years, during which time those decisions may be revised.
Mar-98	1997 10K	McLeodUSA	States also regulate the intrastate carrier access services of the incumbent local exchange carriers. The Company is required to pay access charges to originate and terminate its intrastate long distance traffic. The Company could be adversely affected by high access charges, particularly to the extent that the incumbent local exchange carriers do not incur the same level of costs with respect to their own intrastate long distance services.
Mar-98	1997 10K	McLeodUSA	[A] substantial proportion of [McLeodUSA's subsidiary] ICTC's revenues are derived from access charges imposed on interexchange carriers. Access charge rate structures and rate levels have been modified by recent regulatory changes, and further changes are possible. If such revisions result in a reduction of ICTC's revenues and gross margins, it could have a material adverse effect on the Company.
Mar-98	1997 10K	Electric Lightwave	The [FCC's] new rules [regarding interstate access] substantially increase the costs that ILECs subject to the FCC's price cap rules (price cap local exchange carriers), recover through monthly, non-traffic sensitive access charges and substantially decrease the costs that price cap LECs recover through traffic sensitive access charges. In the May 16 order, the FCC also announced its plan to bring interstate access rate levels more in line with cost. The manner in which the FCC implements this approach to lowering access charge levels may have a material adverse effect on the Company's ability to compete in providing interstate access services.

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Date	Filing	Company	Statement
Mar-99	1998 10K	McLeodUSA	The FCC and various states are considering changes to access charge rate levels and related issues involving support for universal service and other public policy objectives. The impact of these changes on us and our competitors is not yet clear. We could be adversely affected if we do not experience access cost reductions proportionally equivalent to those of our competitors, if our competitors receive a disproportionate share of universal service revenues, or if regulation of incumbent local exchange carriers' access services is reduced. As long as new Internet-based competitors continue to be exempt from these charges, they could enjoy a significant cost advantage in this area.
Mar-00	1999 10K	tw telecom	<p>If regulatory decisions permit the ILECs to charge CAPs and CLECs substantial fees for interconnection to the ILECs' networks or afford ILECs other regulatory relief, such decisions could also have a material adverse effect on the Company. However, the Company believes that the negative effects of the 1996 Act may be more than offset by:</p> <ul style="list-style-type: none"> . the increased revenue available as a result of being able to address the entire local exchange market; . reciprocal compensation with the ILEC; . obtaining access to off-network customers through more reasonably priced expanded interconnection with ILEC networks; and . a shift by IXCs to purchase access services from CAPs and CLECs instead of ILECs. <p>There can be no assurance, however, that these anticipated results will offset completely the effects of increased competition as a result of the 1996 Act.</p>
Mar-00	1999 10K	tw telecom	<p>[T]he FCC is considering proposals to decrease ILEC per-minute access charges, while imposing regulation on CLEC access charges to restrict rates to levels below an established benchmark. Although the Company's business plans have reflected downward pressure on access rates and their impact, these regulatory developments may potentially result in lower rates than anticipated. Management believes that increased volume in services and markets served will offset the impact of switched access rate reduction. However, the degree and timing of the regulatory developments cannot be predicted. In addition, there is no assurance that the Company will be able to compensate for the reduction in switched access revenue from rate reform with other revenue sources.</p>

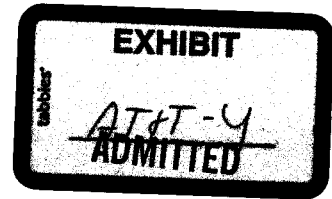
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Date	Filing	Company	Statement
Mar-01	2000 10K	XO	Long distance carriers pay local carriers, including us, interstate access charges for both originating and terminating the interstate calls of long distance customers on the local carriers' networks. Historically, the RBOCs set access charges higher than cost and justified this pricing to regulators as a subsidy to the cost of providing local telephone service to higher cost customers. ... The method selected and the timing of a FCC decision to lower access charge levels or a FCC decision requiring that competitors' access rates be set through negotiation rather than tariffing may reduce access charge revenue that we receive from long distance carriers. Although a FCC decision lowering access charges may reduce our access charge revenues, we do not expect that such a reduction would have a material impact on our total revenues or financial position.
Mar-02	2001 10K	XO	[T]he FCC issued a decision in 2001 setting the rates that competitive local carriers charge to long distance carriers at a level that will gradually decrease over the next three years ... Although this FCC decision lowering access charges will reduce our access charge revenues over time, we do not expect that such a reduction will have a material impact on our total revenues or financial position.
Feb-03	2002 10K	tw telecom	In May 2000, the FCC ordered a substantial reduction in ILEC per-minute access charges and an increase in the flat monthly charge paid by local residential service subscribers for access to interstate long distance service. The FCC also released an order effective in June 2001 that subjects CLECs' interstate switched access charges to regulation. Effective with that order, our rates were reduced and will continue to decline through June 2004 to parity with the ILEC rates competing in each area. ... There is no assurance that any legal challenge [to this order] will be successful or that a successful challenge will change the trend toward lower access charges. The ILEC access reform decision, as well as the CLEC access charge regulation have resulted in reductions in the per-minute rates we receive for switched access service in 2001 and 2002 and will result in further reductions through June 2004. There is no assurance that we will be able to compensate for reductions in switched access revenue resulting from the FCC order with revenue from other sources.

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Date	Filing	Company	Statement
Mar-05	2004 10K	Eschelon	We purchase long distance service on a wholesale basis from an IXC who pays access fees to local exchange carriers for the origination and termination of our long distance communications traffic. Generally, intrastate access charges are higher than interstate access charges. Therefore, to the degree access charges increase or a greater percentage of our long distance traffic is intrastate, our costs of providing long distance services will increase. As a local exchange provider, we bill long distance providers access charges for the origination and termination of those providers' long distance calls. Accordingly, in contrast with our long distance operations, our local exchange business benefits from the receipt of intrastate and interstate long distance traffic. ... The result of any changes to the existing regulatory scheme for access charges or a determination that we have been improperly recording the jurisdiction of our communications traffic could have a material adverse effect on our business
Mar-05	2004 10K	Eschelon	Our costs of providing long distance services, and our revenues for providing local services, also are affected by changes in access charge rates imposed on CLECs. Pursuant to the FCC's 2001 CLEC Access Charge Order, which lowered the rates that CLECs may charge long distance carriers for the origination and termination of calls over local facilities, access rates were reduced during Fiscal 2003 and Fiscal 2004. AT&T and Sprint have appealed the CLEC Access Charge Order to the D.C. Circuit, arguing that the FCC's benchmark rates are too high.
Mar-05	2004 10K	Eschelon	The FCC has stated that existing intercarrier compensation rules constitute transitional regimes and has promised to reform them. ... Because we both make payments to and receive payments from other carriers for the exchange of local and long distance calls, we will be affected by changes in the FCC's intercarrier compensation rules. We cannot predict the impact that any such changes may have on our business.
Mar-07	2006 10K	PAETEC	In general, the FCC benchmark rate policy may prevent PAETEC from raising its access charges with respect to the provision of some carrier services and its reciprocal compensation rates substantially above specified levels. Current FCC policies and regulations also have helped to maintain or reduce the rates that PAETEC's competitors may charge PAETEC for similar wholesale carrier services. As a result, PAETEC currently is able substantially to pass through cost savings to its network services customers. Nevertheless, the outcome of FCC's decisions on intercarrier compensation reform and its effect on PAETEC's business and the businesses of its competitors cannot be predicted.

Source: Company 10-Ks



BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS

KRISTIN K. MAYES - Chairman
GARY PIERCE
PAUL NEWMAN
SANDRA D. KENNEDY
BOB STUMP

IN THE MATTER OF THE REVIEW AND
POSSIBLE REVISION OF ARIZONA UNIVERSAL
SERVICE FUND RULES, ARTICLE 12 OF THE
ARIZONA ADMINISTRATIVE CODE.

Docket No. RT-00000H-97-0137

IN THE MATTER OF THE INVESTIGATION OF
THE COST OF TELECOMMUNICATIONS
ACCESS.

Docket No. T-00000D-00-0672

REJOINDER TESTIMONY OF

DR. DEBRA J. ARON

**On Behalf of
AT&T Communications of the Mountain States, Inc. and TCG Phoenix**

March 5, 2010

PUBLIC VERSION

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DOCKET No. RT-00000H-97-0137
DOCKET No. T-00000D-00-0672
AT&T COMMUNICATIONS OF THE MOUNTAIN STATES, INC.
AND TCG PHOENIX
REJOINDER TESTIMONY OF DR. DEBRA J. ARON

I. Introduction

Q: ARE YOU THE SAME DR. DEBRA J. ARON WHO SUBMITTED DIRECT AND REPLY TESTIMONY IN THIS PROCEEDING?¹

A: Yes, I am.

Q: WHAT IS THE PURPOSE OF YOUR REJOINDER TESTIMONY?

A: I am responding to the Reply Testimony of Lisa Hensley Eckert on behalf of Qwest Corporation and Qwest Communications Company (hereafter referred to as "Qwest"); the Reply Testimony of Don Price filed on behalf of Verizon California, Verizon Business Services, and Verizon Long Distance (hereafter referred to as "Verizon"); the Reply Testimony of Douglas Garrett on behalf of Cox Arizona Telcom; and the Reply Testimony of Douglas Denney filed on behalf of Eschelon Telecom of Arizona,

¹ Direct Testimony of Dr. Debra J. Aron on Behalf of AT&T Communications of the Mountain States, Inc. and TCG Phoenix, *In the Matter of the Review and Possible Revision of Arizona Universal Service Fund Rules, Article 12 of the Arizona Administrative Code and In the Matter of the Investigation of the Cost of Telecommunications Access*, Before the Arizona Corporation Commission, Docket Nos. RT-00000H-97-0137 and T-00000D-00-0672, (hereafter *Aron Direct Testimony*), December 1, 2009; and Reply Testimony of Dr. Debra J. Aron on Behalf of AT&T Communications of the Mountain States, Inc. and TCG Phoenix, *In the Matter of the Review and Possible Revision of Arizona Universal Service Fund Rules, Article 12 of the Arizona Administrative Code and In the Matter of the Investigation of the Cost of Telecommunications Access*, Before the Arizona Corporation Commission, Docket Nos. RT-00000H-97-0137 and T-00000D-00-0672, (hereafter *Aron Reply Testimony*), February 5, 2010.

1 Mountain Telecommunications, Electric Lightwave, McLeodUSA Telecommunications
2 Services, tw telecom of Arizona, and XO Communications Services (hereafter referred to
3 collectively as "Joint CLECs").²

4 **Q: DO YOU HAVE ANY COMMENTS REGARDING YOUR PREVIOUS**
5 **TESTIMONY?**

6 **A:** Yes. As I observed in my Reply Testimony, Tables 1, 2 and 3 of my Direct Testimony
7 report the figures that ALECA and the CLECs provided in discovery for their average
8 access rates. However, my subsequent review of the data provided by tw telecom
9 uncovered a problem with the way tw telecom had computed its average rate. Tw
10 telecom did not use the methodology that I would have expected and that Qwest,
11 Verizon, and AT&T used to calculate its average rate. Indeed, I found that tw telecom's

² Reply Testimony of Douglas Denney on Behalf of Eschelon Telecom of Arizona, Inc.; Mountain Telecommunications, Inc.; Electric Lightwave, LLC; McLeodUSA Telecommunications Services, Inc. d/b/a PAETEC Business Services; tw telecom of Arizona llc; and XO Communications Services, Inc., *In the Matter of the Review and Possible Revision of Arizona Universal Service Fund Rules, Article 12 of the Arizona Administrative Code and In the Matter of the Investigation of the Cost of Telecommunications Access*, Before the Arizona Corporation Commission, Docket Nos. RT-00000H-97-0137 and T-00000D-00-0672, (hereafter *Denney Reply Testimony*), February 5, 2010; Reply Testimony of Douglas Garrett on Behalf of Cox Arizona Telcom, L.L.C., *In the Matter of the Review and Possible Revision of Arizona Universal Service Fund Rules, Article 12 of the Arizona Administrative Code and In the Matter of the Investigation of the Cost of Telecommunications Access*, Before the Arizona Corporation Commission, Docket Nos. RT-00000H-97-0137 and T-00000D-00-0672, (hereafter *Garrett Reply Testimony*), February 5, 2010; Reply Testimony of Lisa Hensley Eckert on Behalf of Qwest Corporation, *In the Matter of the Review and Possible Revision of Arizona Universal Service Fund Rules, Article 12 of the Arizona Administrative Code and In the Matter of the Investigation of the Cost of Telecommunications Access*, Before the Arizona Corporation Commission, Docket Nos. RT-00000H-97-0137 and T-00000D-00-0672, (hereafter *Eckert Reply Testimony*), February 5, 2010; and Reply Testimony of Don Price on Behalf of Verizon, *In the Matter of the Review and Possible Revision of Arizona Universal Service Fund Rules, Article 12 of the Arizona Administrative Code and In the Matter of the Investigation of the Cost of Telecommunications Access*, Before the Arizona Corporation Commission, Docket Nos. RT-00000H-97-0137 and T-00000D-00-0672, (hereafter *Price Reply Testimony*), February 5, 2010.

1 computed rate was *less than half* the rate it would have reported if it had calculated its
2 rate using the same methodology as Qwest, Verizon/MCI and AT&T. In order to
3 confirm whether the average rates of the ALECA members and the other CLECs as
4 provided in the first round of discovery suffered from the same inconsistency as the rate
5 tw telecom provided in discovery, AT&T requested additional information in discovery.
6 I confirmed that Verizon/MCI calculated its rates consistent with the methodology of
7 Qwest and AT&T. However, Integra and XO reported revenues and minutes for
8 elements that are not rated on a minute-of-use basis, which caused their intrastate access
9 rates to be understated and their interstate rates to be overstated. Although Cox provided
10 additional data in response to AT&T's discovery request, what was provided was not
11 responsive to the request and did not provide information that would allow me to
12 determine whether its average rates were consistently calculated. Regarding tw telecom,
13 I understand that tw telecom identified an error in the data that it had originally provided
14 in discovery in response to Staff—an error that was separate from the calculation issue
15 that triggered my review of the rates and AT&T's additional discovery requests. Tw
16 telecom has revised its initial discovery response to Staff, but has not responded to
17 AT&T's discovery request seeking to clarify tw telecom's calculation methodology. The
18 data tw telecom provided in its revised response to Staff provided new data that do not
19 appear to be a modification of the data it originally provided but rather appear to be an

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1 entirely different data draw. Because the new data were provided without the level of
2 detail (disaggregation) that tw telecom originally provided with its initial discovery
3 response, and because tw telecom did not respond to AT&T's request, I am unable to
4 determine whether the revised rates are based on the same inconsistent formula as the
5 original data or whether tw telecom has corrected the problem I discussed in my reply
6 testimony. It appears, however, that the revised rates are based on the same inconsistent
7 formula, in light of the fact that the (new) average rate tw telecom is reporting is vastly
8 inconsistent with the rates that appear in its tariff. Specifically, according to tw telecom's
9 revised discovery response, its average blended intrastate access rate is [BEGIN
10 HIGHLY CONFIDENTIAL INFORMATION] [REDACTED] [END HIGHLY
11 CONFIDENTIAL INFORMATION] cents, while based on its tariffed rates (reported
12 below in Figure 1) its intrastate originating access rate is 3.61 cents and its intrastate
13 terminating access rate is 4.41 cents,³ both of which are far in excess of tw telecom's
14 reported average price. There is no weighted average of those two numbers that can lead
15 to an average rate of [BEGIN HIGHLY CONFIDENTIAL INFORMATION] [REDACTED]
16 [END HIGHLY CONFIDENTIAL INFORMATION] cents. Hence, it would appear
17 that the average rate tw telecom provided in its amended response to Staff is substantially
18 understated.

³ These are the same rates reported by the Joint CLECs' own witness, Mr. Denney, at Table 1 of his Direct Testimony.

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1 At the time of this writing, PAETEC has also not provided the requested information, and
2 therefore its reported average rates cannot be compared to those of Qwest or any other
3 carrier. The rates shown in my Table 2 for PAETEC can only be interpreted as a lower
4 bound on that carrier's comparable average rates.⁴

5 Below are Tables 2 and 3 with the corrected average rates for XO and Integra.⁵

⁴ I understand that Level3 has withdrawn participation in this Docket and has also not provided updated information. Therefore I am deleting Level3's access rates from my updated table.

⁵ Verizon/MCI's recomputation of the average access rates uses local switching minutes, so they are comparable to Qwest's and require no revision.

Table 2 of Aron Direct Testimony (Revised)

**Arizona CLEC Access Charges to Wireline IXC's
for Call Origination and Call Termination Services**

**Bracketed Numbers are Those For Which Necessary Correction is Unknown Due to
Inadequate Data Provided in Discovery**

[BEGIN HIGHLY CONFIDENTIAL INFORMATION]



[END HIGHLY CONFIDENTIAL INFORMATION]

* Average of TCG, AT&T, and SBC LD

** Average of Electric Lightwave, Eschelon, and Mountain Communications

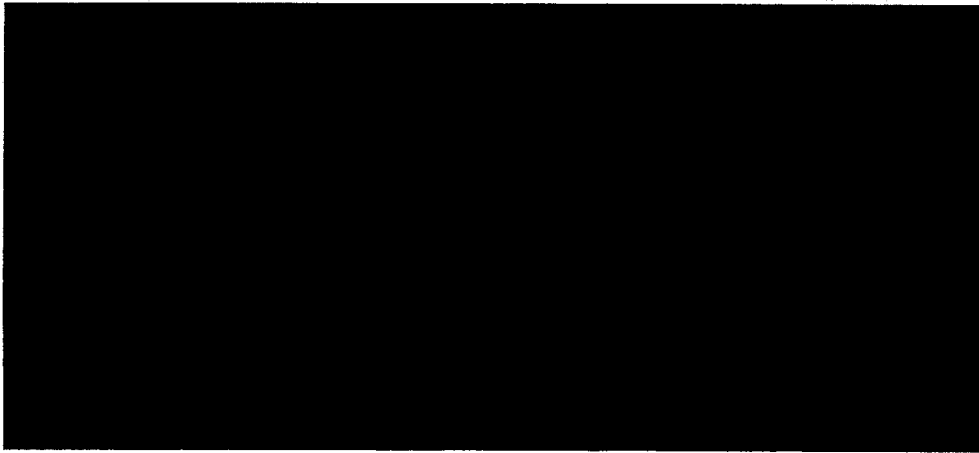
*Sources: CLEC responses to Staff's Data Request STF 1.1 and Integra's response to AT&T's
Request 4.1.*

Table 3 of Aron Direct Testimony (Revised)

Arizona LEC Charges for Call Termination⁶

**Bracketed Numbers are Those For Which Necessary Correction is Unknown Due to
Inadequate Data Provided in Discovery**

[BEGIN HIGHLY CONFIDENTIAL INFORMATION]



[END HIGHLY CONFIDENTIAL INFORMATION]

**** For Integra, intraMTA rates are the average of Electric Lightwave and Eschelon, computed as total reciprocal compensation revenues divided by reciprocal compensation minutes billed to wireless carriers. Integra's intrastate and interstate access rates are the average of Electric Lightwave, Eschelon, and Mountain Communications.**

Sources: Qwest Supplemental Responses to AT&T's Data Requests 3.9, Cox Communications and Verizon Responses to AT&T's Data Request 2.9; Integra Responses to AT&T's Data Request 2.8; Parties' Responses to Staff's Data Request STF 1.1; and Integra's Response to AT&T's Data Request 4.1.

⁶ I have modified the title of Table 3 to clarify that the intrastate and interstate access rates shown are not the termination rates, but the average rate over origination and termination, for "one side" of a toll call (origination or termination but not both).

1 The changes in Table 2 also affect Figure 1 in my Direct Testimony. I am providing an
2 updated version of Figure 1 as Exhibit DJA-Rejoinder 1.⁷

3 **Q: PLEASE SUMMARIZE YOUR CONCLUSIONS FROM YOUR REVIEW**
4 **OF THE SUPPLEMENTAL DATA PROVIDED IN DISCOVERY SO FAR.**

5 A: I have found that Qwest, Verizon, and AT&T calculated their rates on a consistent basis.
6 To the extent the other parties provided any data, the data show that they used a
7 methodology to calculate their average rates that understate their average rates so that
8 they appear to be closer to Qwest's rates than they would if computed on an apples-to-
9 apples basis. The fact that McLeod USA (PAETEC), tw telecom, and Cox have not
10 provided sufficient data to determine how their rates were calculated calls their reported
11 rates into question. The fact that tw telecom's reported average blended rate is far out of
12 line with its tariffed rates further calls tw telecom's reported rate into question. I would
13 advise the Commission to view the reported rates of these three CLECs as lower bounds
14 on their actual average rates, and therefore as lower bounds on the degree of monopoly
15 markup contained in those rates.

⁷ I have also modified the labels for the intrastate and interstate average rates to clarify that the rates shown are the average rate over origination and termination, for "one side" of a toll call (origination or termination but not both). I also replaced Integra's local termination rate so that, consistent with the other numbers in the chart, it is based on 2008 rather than 2009 revenues and minutes.

1 **Q: DO YOU HAVE ANY COMMENTS ON THE REPLY TESTIMONIES**
2 **FILED BY THE PARTIES OVERALL?**

3 **A:** Yes. With respect to the issues I have addressed in my testimony, the Reply testimonies
4 provided very little in the way of arguments or analyses that I had not either already
5 addressed in my Direct Testimony and/or in my Reply Testimony. Hence, I will keep my
6 comments brief in this round and refer the Commission to the extent possible to my
7 earlier testimony. One of the most significant areas of dispute between the parties,
8 however, is that Qwest's proposal (supported by Verizon, ALECA, and Staff) is to reduce
9 all LECs' intrastate access rates to Qwest's intrastate access rate; while AT&T's proposal
10 (supported by Sprint) is to reduce all ILECs' intrastate rates to their interstate rate and all
11 CLECs' intrastate rates to the intrastate rate of the competing ILEC. In addition, Qwest's
12 proposal, like AT&T's, is to permit the ILECs only partial recovery of forgone revenues
13 from an expanded AUSF fund, with the opportunity for the rest of the forgone revenues
14 to be recovered via increased retail rate caps. ALECA requests all forgone revenues to be
15 recovered from an AUSF fund. I believe it will help advance the Commission's thinking
16 to provide an analysis of the differences between these proposals, which I provide in
17 Section II.

18 **II. Comparison of Qwest/Verizon proposal vs. AT&T/Sprint proposal**

19 **Q: THE ILECS IN THIS PROCEEDING (QWEST, VERIZON, AND ALECA) HAVE**
20 **PROPOSED TO CAP THE ACCESS RATES OF ALL PARTIES AT QWEST'S**
21 **INTRASTATE ACCESS RATE. WHAT ARE THE PRACTICAL**

1 **IMPLICATIONS OF THIS PROPOSAL VIS À VIS AT&T'S PROPOSAL TO**
2 **CAP THE ILECS' ACCESS RATES AT THEIR INTERSTATE LEVEL AND**
3 **THE CLECS' RATES AT THE RATES OF THE COMPETING ILEC?**

4 A: The differences in the practical effect of these proposals fall into three categories: the
5 effect on long distance customers and economic efficiency via lower average access
6 rates; the effect on arbitrage opportunities; and the effect on AUSF funding.

7 The biggest difference in practical terms—that is, in terms of how the proposals will
8 affect overall average access rates, retail toll prices, overall LEC revenues, economic
9 efficiency, and consumer welfare—is that under the Qwest proposal, Qwest will be able
10 to charge intrastate access rates that are double the rates Qwest would be required to
11 charge under AT&T's proposal. Quantitatively, this is the most important single
12 difference between the proposals because Qwest accounts for **[BEGIN HIGHLY**
13 **CONFIDENTIAL INFORMATION]** [REDACTED] **[END HIGHLY**
14 **CONFIDENTIAL INFORMATION]** of all intrastate access minutes in Arizona.⁸ If
15 Qwest is not required to reduce its access rates, the overall reduction to the average
16 intrastate access rates paid by IXC's in Arizona will be substantially muted and the effect
17 on reducing long distance prices will be correspondingly muted as well. Moreover, I
18 understand that AT&T's elimination of its in-state connection fee (ISCF), which would

⁸ This estimate is based on the sum of intrastate minutes reported by all carriers that provided information for this proceeding.

1 be a significant benefit to consumers, occurs only if intrastate access rates are reduced to
2 interstate levels (i.e., AT&T's proposal).

3 In addition to the effect on Qwest's rates, under the ILEC proposal the average rate
4 charged by ALECA companies would be higher than under the AT&T proposal. The
5 effect would differ for each ALECA member, however. There would in fact be several
6 ALECA members that would charge more under AT&T's proposal than under Qwest's,
7 but these are very small carriers and they collectively account for less than one fourth of
8 the total ALECA intrastate access minutes. Hence, overall, the average intrastate access
9 cost to IXC's charged by ALECA members would be lower under AT&T's proposal than
10 under Qwest's.

11 In addition, each CLEC would charge less under AT&T's proposal than under Qwest's.

12 Therefore, because the rates for intrastate access paid by IXC's would be lower overall
13 under AT&T's proposal than under Qwest's, intrastate long distance customers in
14 Arizona would experience significantly greater benefit under AT&T's proposal than
15 under Qwest's proposal, and economic efficiency would be greater under AT&T's
16 proposal than under Qwest's.

1 Q: **HOW WOULD THE TWO PROPOSALS DIFFER WITH RESPECT TO**
2 **ARBITRAGE OPPORTUNITIES?**

3 A: While there is more than one form of arbitrage related to distorted access rates, Qwest's
4 proposal will not solve any arbitrage problem, while AT&T's will solve the one form of
5 arbitrage that *can* be solved by this Commission, interstate-intrastate traffic diversion.
6 There are two general kinds of arbitrage that are relevant for these discussions: arbitrage
7 involving diversion of traffic from one jurisdiction to another to take advantage of the
8 differences in rates; and arbitrage involving schemes such as call-pumping that take
9 advantage of the difference between the rate and the cost of providing the service.

10 In fact, both kinds of arbitrage are better managed by AT&T's proposal than by Qwest's.
11 Regarding traffic diversion, AT&T's proposal eliminates the difference between
12 interstate and intrastate rates, thereby eliminating traffic-diverting arbitrage between
13 interstate and intrastate traffic. Qwest's proposal perpetuates differences between
14 interstate and intrastate rates and is thereby inferior for reducing traffic shifting forms of
15 arbitrage.

16 Regarding call-pumping and similar schemes, AT&T's proposal is superior as well. For
17 almost all traffic, under AT&T's proposal the intrastate rate will be closer to the ILEC's
18 cost of providing access functionality, thereby affording less opportunity for arbitrage.
19 For those ALECA members who would charge a higher intrastate rate under AT&T's
20 proposal, the opportunity for call-pumping-type arbitrage is effectively the same under

1 either proposal, because in either case the best opportunity for call pumping would be
2 against the interstate rate, which would be unaffected by both proposals. Qwest appears
3 to suggest that call-pumping-type schemes would be more effectively limited by its
4 proposal,⁹ but this assertion is incorrect. It fails to recognize that reducing the intrastate
5 rate below the interstate rate will not decrease call-pumping arbitrage opportunities
6 relative to reducing intrastate rates to interstate rates, because in either case the carrier
7 can arbitrage against the interstate rate. This Commission does not have control over
8 arbitrage opportunities created by interstate access rates, reform of which requires FCC
9 action. Hence, this Commission cannot fully solve the problem of call-pumping arbitrage
10 through any form of intrastate access reform. While not a full solution, AT&T's proposal
11 would be more effective than Qwest's proposal at limiting call-pumping incentives,
12 which is the relevant issue before this Commission.¹⁰

⁹ See, Qwest's Response to AT&T Data Request 5-001, and *Eckert Reply Testimony*, p. 3.

¹⁰ Qwest references in testimony and in discovery (Qwest's Response to AT&T Data Request 5-001, and *Eckert Reply Testimony*, p. 3) a third form of arbitrage, in which VoIP providers that arrange with LECs to deliver their originating VoIP traffic to the PSTN will contract with the LEC with high access fees, presumably in order to share in the revenue from the high access fees. This form of arbitrage, however, would also not be eliminated by Qwest's proposal. Indeed, under either Qwest's or AT&T's proposal, VoIP providers with an inclination to engage in this form of arbitrage would continue to have the ability and incentive to shop for the LEC with the highest originating *interstate* switched access rates, which would be the same under either proposal, and route all its traffic through that LEC. Hence, again, full resolution of this form of arbitrage requires FCC action on interstate rates, which are not under this Commission's control.

1 Q: HOW DO THE TWO PLANS DIFFER WITH RESPECT TO THEIR
2 BURDENS ON UNIVERSAL SERVICE?

3 A: Dr. Oyefusi has shown that Qwest can reduce its intrastate rates to its interstate levels and
4 recover the forgone revenue entirely from rate increases without undue burden on
5 consumers and no burden on universal service funds.¹¹ Therefore, with respect to Qwest
6 there need not be any difference between the proposals as to their effect on AUSF.
7 Regarding the ALECA members, the difference between the plans depends, of course, on
8 the extent to which forgone revenues are recovered through retail rates rather than
9 through an AUSF fund. Dr. Oyefusi testified in his Reply Testimony that ALECA's
10 proposal, which is the same as Qwest's proposal regarding access rates, combined with
11 the proposal to recover all forgone revenues through USF funds, would be more
12 burdensome on USF funds than AT&T's proposal (which includes partial recovery via
13 retail rates and partial recovery via AUSF funding).¹²

¹¹ Direct Testimony of Dr. Ola Oyefusi on Behalf of AT&T Communications of the Mountain States, Inc. and TCG Phoenix, *In the Matter of the Review and Possible Revision of Arizona Universal Service Fund Rules, Article 12 of the Arizona Administrative Code and In the Matter of the Investigation of the Cost of Telecommunications Access*, Before the Arizona Corporation Commission, Docket Nos. RT-00000H-97-0137 and T-00000D-00-0672, December 1, (hereafter, *Oyefusi Direct Testimony*), p. 61, footnote 68.

¹² Reply Testimony of Dr. Ola Oyefusi on Behalf of AT&T Communications of the Mountain States, Inc. and TCG Phoenix, *In the Matter of the Review and Possible Revision of Arizona Universal Service Fund Rules, Article 12 of the Arizona Administrative Code and In the Matter of the Investigation of the Cost of Telecommunications Access*, Before the Arizona Corporation Commission, Docket Nos. RT-00000H-97-0137 and T-00000D-00-0672, February 5, 2010, pp. 20-21.

1 Q: ARE THERE SIMILARITIES BETWEEN QWEST'S AND AT&T'S
2 PROPOSALS?

3 A: Yes. Unlike ALECA's proposal, both Qwest and AT&T advocate for at least partial
4 recovery of the LECs' forgone access revenues through increased caps on retail prices
5 and the use of a benchmark. Both Qwest and AT&T acknowledge that at least in the
6 short run, some revenue recovery may be necessary through an AUSF fund, but that this
7 should be balanced with the more economically efficient mechanism of at least partial
8 recovery through increased retail prices. ALECA, in contrast (and alone among all the
9 parties), asserts that it is entitled to recovery of all forgone access revenues via draws
10 from an expanded AUSF fund.

11 Q: PLEASE SUMMARIZE YOUR COMPARISON OF THE TWO PLANS.

12 A: I have summarized the key features of the plans in the following table:

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	Qwest Proposal	AT&T Proposal	ALECA Proposal
Access reform is necessary and should happen now	Yes	Yes	Yes
Carriers should be permitted the opportunity to recover revenues forgone due to access reform	Yes	Yes	Yes
Intrastate access rates should be reduced for:	All LECS except Qwest	All LECS	ALECA members and possibly CLECs
ILECs' intrastate access rates should be reduced to:	Qwest's intrastate access rates	Their own interstate access rates	Qwest's intrastate access rates
CLECs' intrastate access rates should be reduced to:	Qwest's intrastate access rates	The intrastate rates of the competing ILEC in their territory	No specific proposal regarding CLECs
Access rates should be reduced:	Immediately for CLECs. Rural ILECs' rates should be reduced over a period of 1 to 3 years	Immediately	Over a period between 1 and 2 years
Forgone revenue should be recovered via:	Retail rate increases, the schedule of which will be established through a rulemaking process, combined with AUSF support	Staged retail rate increases with AUSF support initially and declining as retail rates increase	Entirely through AUSF support
Eliminates disparity between interstate and intrastate rates?	No	Yes	No
Expected reductions in call-pumping-type arbitrage?	Yes	Yes, to a greater extent than the other two proposals	Yes
Expected reduction in retail toll prices?	Muted	Greatest	Muted

1 AT&T's plan is superior to the Qwest plan. It generates greater consumer benefits and
2 greater increases in efficiency. While neither plan can entirely eliminate arbitrage
3 opportunities, AT&T's plan provides superior reductions in opportunities for call
4 pumping arbitrage, and much superior reductions in traffic-shifting arbitrage
5 opportunities. AT&T's plan need not require more AUSF funding than Qwest's plan—in
6 fact, compared to ALECA's plan to recover all forgone access revenues via AUSF
7 funding, AT&T's plan places a reduced burden on AUSF funds.

8 **III. Response to the Reply Testimony of Don Price on Behalf of Verizon**

9 **Q: MR. PRICE OF VERIZON CALLS INTO QUESTION AT&T'S DESCRIPTION**
10 **OF THE ACCESS REFORM POLICIES IN A NUMBER OF STATES,**
11 **CLAIMING THAT AT&T'S PROPOSAL IS "NOT THE NORM" FOR STATES**
12 **THAT HAVE PROCEEDED WITH INTRASTATE ACCESS REFORM.¹³ IS THE**
13 **PROPOSAL SUPPORTED BY VERIZON "THE NORM" OF ACCESS**
14 **REFORM?**

15 **A:** No. While I believe there is no single access reform plan that can be called "the norm"
16 over all 34 states that have engaged in access reform over the last 15 years, I am aware of
17 only one state that has adopted a plan akin to the one Verizon supports.¹⁴ In contrast,
18 there are several states that have adopted the parity requirement that ILECs must mirror

¹³ *Price Reply Testimony*, p. 48 and footnote 100.

¹⁴ That state is Maryland. Massachusetts, Ohio, and Texas require all CLECs to mirror their intrastate access rates to the intrastate rate of the largest ILEC in the state, but also require the largest ILEC to mirror its intrastate rates to its interstate rates. Hence, these plans are effectively the same as AT&T's plan with respect to ILEC rates, and are identical for CLECs that operate in the territory of the largest ILEC in the state.

1 their intrastate rates to their interstate rates, as in AT&T's proposal.¹⁵ And many states
2 have required CLECs to cap their rates at the rate of the competing ILEC in its territory,
3 as in AT&T's proposal.¹⁶ States that have adopted plans akin to AT&T's proposal
4 regarding CLEC and ILEC rates—i.e., they require ILECs to establish parity between
5 their interstate and intrastate rates, and require CLECs to cap their rates at the ILEC's
6 rate—include Ohio, Texas, and New Jersey. In New Jersey Verizon proposed the same
7 plan it is supporting here in Arizona and the Board of Public Utilities rejected it.¹⁷

¹⁵ Georgia (all ILECs), Indiana (major ILEC and rural ILECs), Kansas (all ILECs), Kentucky (major ILEC), Michigan (all ILECs), Nevada (major ILEC), Wisconsin (major ILEC), Mississippi (major ILEC), Tennessee (major ILEC), West Virginia (major ILEC), Ohio (all ILECs), Texas (ILECs with over 4 million lines and CLECs), Maine (all ILECs), New Mexico (all ILECs), Massachusetts (major ILEC and CLECs), and New Jersey (all ILECs). In Michigan, the mirroring requirement was imposed only on LECs with over 250,000 lines in the state until December of last year, when the legislature passed a new law that requires all LECs to mirror interstate rates over a phase-in period.

¹⁶ Louisiana, New Hampshire, Virginia, Washington, Missouri, New York, and Pennsylvania. Washington caps only terminating rates. Missouri, New York and Pennsylvania allow for a lifting of the cap if the CLEC can demonstrate higher costs. No CLEC has done so to my knowledge.

¹⁷ In addition, Mr. Price is incorrect in his characterization of the Wisconsin statute. The Wisconsin statute requires all price regulated LECs to reduce their intrastate rates to interstate levels, not just price-regulated carriers with over 150,000 lines. The statute provides a longer timeline for carriers with fewer than 150,000 lines to reduce their intrastate rates to their interstate levels, and does not require those carriers to reduce their CCL all the way to zero. Mr. Price is also incorrect about Indiana. While the Indiana statute simply has a provision that intrastate switched access rates that are in parity with interstate rates shall be deemed just and reasonable, the Indiana commission has ordered AT&T and rural ILECs to mirror interstate rates. See, Opinion, *Petition of Indiana Bell Telephone Company, Incorporated for Waiver of Requirements of the Orders in Cause No. 39369 and to Continue the "Instant" Mirroring of Inter-State Access Tariffs*, Before the Indiana Utility Regulatory Commission, Cause No. 43262, June 27, 2007 ("The Commission has a long history of requiring that intrastate access rates mirror interstate access rates. The policy was reaffirmed in Cause 39369 and supported by the mirroring obligations set out in AT&T Indiana's alternative regulation plans approved in 2001 and 2004. The practice of mirroring was most recently reaffirmed for rural local exchange carriers (RLECs) in the Commission's March 17, 2004, Final Order in Cause No. 42144").

1 **Q: MR. PRICE INVOKES YOUR TESTIMONY IN SUPPORT OF VERIZON'S**
2 **OPPOSITION TO EXPANDING THE AUSF FUND.¹⁸ PLEASE COMMENT.**

3 A: I agree with Mr. Price that the most economically efficient means of replacing revenue
4 that would be forgone to ALECA members as a result of access reform would be by
5 providing them the opportunity to increase retail prices rather than and to the exclusion of
6 any recovery from an AUSF fund. However, from a policy perspective, I recognize that
7 the Commission faces the pragmatic problem that it may not want to impose the entire
8 recovery on customers in a single-stroke-increase in retail prices, because of the possible
9 rate shock effect on the affected customers. It is efficient and, in my view, equitable, for
10 customers to bear the costs they cause and that can only be done if, eventually, access
11 revenues forgone are recovered entirely via increased retail rates. But if the Commission
12 is concerned about rate shock to consumers a reasonable approach to access reform
13 would be to reduce access rates immediately, in order to achieve the efficiency and
14 consumer benefits I have discussed; and ease in the necessary retail rate increases, in
15 order to limit rate shock, using the AUSF as a transitional buffer. AT&T has proposed a
16 number of illustrations of how this gradual adjustment would work.¹⁹

¹⁸ Price Reply Testimony, p. 26.

¹⁹ Oyefusi Direct Testimony, pp. 63-68.

1 **IV. Response to the Reply Testimony of Douglas Garrett on Behalf of Cox Arizona**
2 **Telcom**

3 Q: MR. GARRETT OF COX OPINES THAT "SETTING A CAP [ON CLEC
4 ACCESS RATES] WITH FLEXIBILITY TO ESTABLISH RATES MODESTLY
5 ABOVE THE ILEC WOULD RECOGNIZE THE DIFFERENCES IN CLEC
6 NETWORKS AND COSTS, WHILE AVOIDING THE COSTLY AND LIKELY
7 CONTENTIOUS EXAMINATION OF INDIVIDUAL CLEC COSTS."²⁰ IS THIS
8 A SOUND PROPOSAL?

9 A: No. There is absolutely no evidence in the record that CLECs' costs of providing
10 switched access services are higher than ILECs' costs. If they are higher, there is no
11 evidence that they are "modestly" higher, 10% higher,²¹ or any other particular amount
12 higher. The CLECs cannot have it both ways. If they want prices based on their costs—
13 which, as I have explained is not consistent with sound economic principles of
14 competition, which would lead to CLEC prices capped at the ILECs' rates—they must
15 submit to examination of their costs in the context of a cost proceeding. If they want to
16 avoid the scrutiny of a cost proceeding, they have no basis for proposing any arbitrary
17 markup over ILECs' rates.

²⁰ Garrett Reply Testimony, p. 6.

²¹ Mr. Garrett references the California PUC's adoption of a CLEC rate cap at the ILEC rate + 10%. There was no evidence provided in the California case that CLECs' costs are 10% higher than ILECs' costs, and therefore whatever the reasoning behind the CPUCs' decision (which it did not provide), it could not have been justified on the basis of cost evidence.

1 **V. Response to the Reply Testimony of Douglas Denney on Behalf of Joint CLECs**

2 **Q: DO YOU HAVE ANY OVERALL COMMENTS ON MR. DENNEY'S REPLY**
3 **TESTIMONY?**

4 **A:** Yes. Mr. Denney largely repeats his points from his Direct Testimony. I have responded
5 to most of the issues Mr. Denney addresses in his Reply Testimony either in my Direct
6 Testimony or in my Reply Testimony. Rather than reiterate these arguments, I have
7 prepared a table, attached as Exhibit DJA-Rejoinder 2, that lists each of the arguments in
8 Mr. Denney's Reply Testimony and points the Commission to my response to each
9 argument in my Direct and/or Reply testimonies (and/or, in some cases, to Dr. Oyefusi's
10 testimony). I will limit my Rejoinder Testimony only to new arguments or those that
11 require a bit more elaboration.

12 **Q: MR. DENNEY CLAIMS THAT QWEST'S INTRASTATE RATE IS NOT**
13 **REALLY HIGHER THAN ITS INTERSTATE RATE BECAUSE THE**
14 **APPARENT DIFFERENCE IS JUST A MISLEADING ARTIFACT OF**
15 **DIFFERENT RATE STRUCTURES.²² IS THAT TRUE?**

16 **A:** No. It is not true. Mr. Denney's argument is that to "properly compare Qwest's
17 interstate and intrastate access rates" requires converting Qwest's federal Subscriber Line
18 Charge (SLC) to a per minute basis and adding it to Qwest's interstate access rate.²³

²² *Denney Reply Testimony*, pp. 21-22. It is noteworthy that Mr. Denney does not even attempt to argue that CLECs' intrastate rates are not higher than their interstate rates.

²³ *Denney Reply Testimony*, p. 22.

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1 This is incorrect because the federal Subscriber Line Charge is not an intercarrier access
2 rate element. The switched access rates are the collection of wholesale rate elements
3 charged by the LEC to IXC's for originating and/or terminating toll traffic. The SLC is a
4 monthly fee charged by LECs to the LECs' own end-user customers.²⁴ In fact, the FCC
5 created the SLC precisely so that the associated revenues would be removed from
6 intercarrier access.²⁵ They were removed in order to decrease the amount of implicit
7 subsidies contained in the interstate switched access rates and replace them with fees that
8 are more consistent with cost causation by assessing them directly on the LECs' end
9 users, and on a per-month rather than per-minute basis.²⁶

10 The same should be done in the intrastate jurisdiction. As I explained in my Reply
11 Testimony, the analog in the intrastate jurisdiction of removing implicit subsidies from
12 the interstate access rate and recovering them through a SLC imposed on LECs' end-user
13 customers would be to reduce the intrastate access rates and recover the forgone revenues
14 through opportunities for increased retail prices for local exchange service.

²⁴ The SLC is a fixed monthly charge levied directly by the LEC to its customers that appears on the customers' local telephone bill. See, FCC website, "What is the Subscriber Line Charge and why do I have to pay this charge?" <http://www.fcc.gov/cgb/telephone.html> (accessed March 1, 2010).

²⁵ Sixth Report and Order in CC Docket Nos. 96-262 and 94-1, Report And Order in CC Docket No. 99-249, Eleventh Report and Order in CC Docket No. 96-45, *In the Matter of Access Charge Reform and Price Cap Performance Review for Local Exchange Carriers et al.*, Before the Federal Communications Commission, CC Docket Nos. 96-262 and 94-1 et al., FCC 00-193, (released May 31, 2000), (hereafter *FCC CALLS Order*), ¶¶ 31, 65.

²⁶ *FCC CALLS Order*, ¶¶ 65-68.

1 Q: MR. DENNEY ASSERTS THAT A BENCHMARK FOR CLEC ACCESS RATES
2 OTHER THAN COST IS "ARBITRARY."²⁷ IS THE BENCHMARK PROPOSED
3 BY AT&T—THAT CLECS' INTRASTATE ACCESS RATES BE CAPPED AT
4 THE RATE OF THE COMPETING ILEC—ARBITRARY?

5 A: No, on the contrary, it is *the only benchmark proposed in this case* that is driven by
6 economic principles. As I have explained in my Direct and Reply testimonies, in a
7 competitive marketplace, CLECs would not be permitted by access customers to charge a
8 rate higher than that of the incumbent with whom it competes. For regulation to mimic to
9 the extent possible the outcome of a competitive market, the regulator would therefore
10 cap the CLECs' intrastate access rates at the competing ILEC's level. This is exactly
11 what the FCC ordered for CLECs' interstate access rates. From an economic standpoint,
12 any benchmark other than the rate charged by the competing ILEC, including capping the
13 CLECs' intrastate access rates at Qwest's intrastate rate in 1999, is arbitrary.

14 Q: MR. DENNEY CLAIMS THAT THE TESTIMONY PROVIDED BY THE
15 PARTIES REGARDING THE MARKET POWER OF LECS OVER ACCESS
16 SERVICE APPLIES ONLY TO TERMINATING ACCESS. HE THEN ARGUES
17 THAT COMPETITION FROM IXCS CAN EFFECTIVELY DISCIPLINE
18 ORIGINATING ACCESS RATES.²⁸ PLEASE COMMENT.

19 A: He is incorrect on both counts. I explained in my Direct Testimony the conditions that
20 generate market power in originating and terminating access services.²⁹ I elaborated on
21 the market factors that generate market power specifically in originating access in my

²⁷ Denney Reply Testimony, p. 21.

²⁸ Denney Reply Testimony, pp. 7-8.

²⁹ Aron Direct Testimony, pp. 86-87.

1 Reply Testimony³⁰ and will not repeat that analysis here. While Mr. Denney is correct to
2 observe that it is appropriate to analyze market power in originating and terminating
3 access separately, and I have done so, he is incorrect in suggesting that LECs have no
4 market power in originating access.³¹

5 **Q: DO CLECS' ORIGINATING ACCESS RATES APPEAR TO REFLECT**
6 **MARKET POWER?**

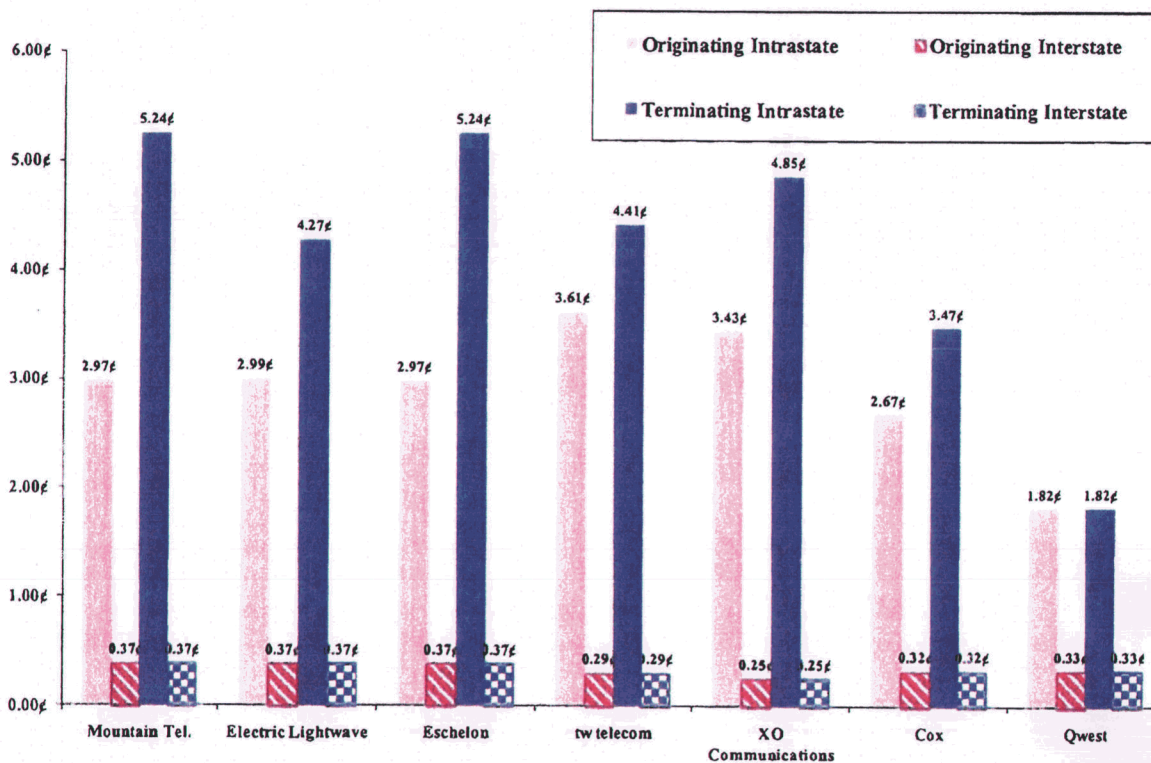
7 **A:** Yes. Figure 1 compares CLECs' intrastate originating and terminating rates to their
8 interstate rates and to the rates of Qwest.³² Although originating rates tend to be less than
9 terminating rates, it is clear that there is significant market power in originating access.
10 Intrastate originating and terminating rates are many times their interstate equivalent for
11 all CLECs, and all CLECs' intrastate rates are higher than Qwest's.

³⁰ Aron Reply Testimony, pp. 18-19.

³¹ Denney Reply Testimony, p. 11.

³² For this comparison, I have replicated the methodology Mr. Denney uses in Table 1 of his Direct and Reply Testimonies to estimate LECs' average originating and terminating rates. These rates do not suffer from the problems I identified at the beginning of this Rejoinder Testimony affecting some of the CLECs' calculated rates because these estimates are based on tariffed rates rather than revenue data. I was unable to find PAETEC's tariffed interstate rates, and have therefore excluded PAETEC from this comparison.

Figure 1
Comparison of CLECs' Originating and Terminating Rates to Qwest's Rates*



* Rates computed using the methodology used by Mr. Denney in his Direct Testimony. See, *Denney Direct*, pp. 18-19.

Source: Company tariffs. In some cases the tariff was not available on the company's website, so I referenced the tariffed rates provided in discovery, in response to Staff Data Requests STF 1.1 and STF 1.21

1 Q: MR. DENNEY ARGUES THAT IXCS CAN DISCIPLINE EXCESSIVE
2 ORIGINATING ACCESS RATES CHARGED BY A GIVEN LEC BY
3 ATTRACTING THAT LEC'S CUSTOMERS TO ITS OWN LOCAL EXCHANGE
4 SERVICE, THEREBY AVOIDING THE ORIGINATING ACCESS CHARGES
5 ENTIRELY.³³ PLEASE COMMENT.

6 A: Mr. Denney's argument is not correct, for reasons relating to the inability of IXC's to
7 adequately deaverage retail prices, as I explained in my earlier testimonies and will not
8 repeat here. I will only point out here that if Mr. Denney's argument were correct,
9 vertically integrated telephone providers (i.e., those that provide both local and long
10 distance service to the same customers) would create sufficient market discipline to drive
11 CLECs' originating intrastate access rates to at least the ILECs' intrastate levels. This
12 has not happened. Vertically integrated telephone providers, including Verizon, Qwest,
13 and all of the Joint CLECs, have operated in Arizona since at least 2001 and the LECs'
14 originating intrastate rates continue to reflect market power, as I demonstrated above.

15 Q: HAS THE FCC RETREATED FROM ITS 2001 CONCLUSION THAT
16 ORIGINATING ACCESS IS A MONOPOLY SERVICE?

17 A: No, the FCC has not indicated any retreat from its 2001 conclusion that originating
18 access is a monopoly service,³⁴ and as recently as 2008 then-chairman Martin proposed

³³ Denney Reply Testimony, p. 13.

³⁴ See, Seventh Report and Order and Further Notice of Proposed Rulemaking, *In the Matter of Access Charge Reform and Reform of Access Charges Imposed by Competitive Local Exchange Carriers*, Before the Federal Communications Commission, CC Docket No. 96-262, FCC 01-146, (released April 27, 2001), ¶¶ 29-31.

1 eliminating originating access charges entirely (i.e., capping them at zero) for ILECs and
2 CLECs.³⁵

3 **Q: MR. DENNEY ARGUES THAT CLECS' ACCESS RATES DO NOT EVIDENCE**
4 **MARKET POWER, BECAUSE IF CLECS HAD MARKET POWER THEIR**
5 **ACCESS RATES WOULD BE EVEN HIGHER.³⁶ IS THIS PERSUASIVE?**

6 **A:** No. Mr. Denney fails to indicate what the rates would have to be to demonstrate market
7 power, but the reality is that in any market, even a monopolist does not charge an infinite
8 price. Its rate is limited to some finite level not by competition, but by other factors. In
9 the case of CLECs, these factors may include the desire to avoid attention and the
10 associated scrutiny of regulators, and the desire to avoid litigation.

³⁵ See, Order on Remand and Report and Order and Further Notice of Proposed Rulemaking, *In the Matter of High-Cost Universal Service Support and Federal-State Joint Board on Universal Service et al.*, Before the Federal Communications Commission, WC Docket No. 05-337 and CC Docket 96-45 et al., FCC 08-262, (released November 5, 2008), Appendix A, ¶ 229.

³⁶ *Denney Reply Testimony*, p. 10.

1 Q: MR. DENNEY CLAIMS THAT RECIPROCAL COMPENSATION RATES ARE
2 NOT A GOOD BENCHMARK FOR COST BECAUSE, EVEN THOUGH THEY
3 ARE BASED ON QWEST'S COSTS, THE COST OF TERMINATING LOCAL
4 TRAFFIC IS NOT THE SAME AS THE COST OF TERMINATING TOLL
5 TRAFFIC.³⁷ PLEASE COMMENT.

6 A: XO, tw telecom, and Integra, as well as Cox, Qwest and MCI, acknowledged in
7 discovery that local call termination and access services are the same functionality.³⁸ Dr.
8 Oyefusi further addresses Mr. Denney's claim in his Rejoinder Testimony.

9 Q: MR. DENNEY ALSO CLAIMS THAT EVEN THOUGH QWEST'S
10 RECIPROCAL COMPENSATION RATES WERE BASED ON QWEST'S
11 COSTS, "THESE RATES HAVE NOTHING TO DO WITH THE COST
12 INCURRED BY OTHER CARRIERS (CLECS AND RLECS) IN ARIZONA."³⁹
13 PLEASE COMMENT.

14 A: According to the federal rules,⁴⁰ CLECs pay reciprocal compensation rates based on the
15 ILEC's costs unless they can prove that their own costs are higher. CLECs have
16 therefore had the opportunity for over a decade to make a cost showing to demonstrate
17 that their costs exceed the ILECs' reciprocal compensation rates in Arizona and they
18 have neither claimed nor shown in this proceeding that they ever did so.

³⁷ Denney Reply Testimony, pp. 25-26.

³⁸ Qwest's Response to Staff Data Request STF 1.24; Verizon's Response to AT&T's Data Request 2.16; XO's and tw telecom's Joint Response to Staff Data Request STF 1.24; PAETEC's Response to Staff Data Request STF 1.24; and Integra's and Cox's Responses to AT&T's Data Request 2.14.

³⁹ Denney Reply Testimony, p. 26.

⁴⁰ First Report and Order, *In the Matter of Implementation of the Local Competition Provisions in the Telecommunications Act of 1996 Interconnection between Local Exchange Carriers and Commercial Mobile Radio Service Providers*, Before the Federal Communications Commission, CC Docket 96-98 and CC Docket No. 95-185, (released August 8, 1996), ¶ 1089; and 47 CFR § 51.711.

1 Q: MR. DENNEY ARGUES THAT CLECS COULD NOT RECOVER LOST
2 ACCESS REVENUES IN THE RETAIL MARKET IF (AS UNDER QWEST'S
3 PROPOSAL) QWEST DID NOT HAVE TO REDUCE ITS INTRASTATE
4 ACCESS RATES, BECAUSE THEN QWEST WOULD NOT INCREASE ITS
5 RETAIL LOCAL RATES.⁴¹ IS THIS A VALID ARGUMENT?

6 A: No. Any CLEC that cannot compete with Qwest in Qwest's territory by charging the
7 same access rates as Qwest currently charges and the same retail rates as Qwest currently
8 charges is inefficient and should not be rewarded with a subsidy source of income from
9 monopoly access rates. The fact that CLECs have been permitted to charge access rates
10 well in excess of Qwest's rates for over a decade does not provide a justification for
11 perpetuating that inefficiency.

12 Q: MR. DENNEY CLAIMS THAT THE "1999 TIME FRAME" WAS WHEN
13 "MOST" CLECS WERE ENTERING THE MARKET IN ARIZONA AND
14 THEREFORE QWEST'S INTRASTATE ACCESS RATES WOULD HAVE
15 BEEN "CONSIDERED" BY THE CLECS WHEN THEY WERE
16 DECIDING WHETHER OR NOT TO ENTER.⁴² PLEASE COMMENT.

17 A: I addressed the substance of this claim in my Reply testimony.⁴³ I add here that the
18 CLECs have provided no evidence in support of any of the assertions in this claim,
19 including no evidence of which CLECs entered when, and no evidence that Qwest's
20 intrastate access rates played a material role (or any role) in any CLEC's entry decision.

⁴¹ Denney Reply Testimony, pp. 31-32.

⁴² Denney Reply Testimony, pp. 29-30.

⁴³ Aron Reply Testimony, pp. 23, 31-34, and Exhibit DJA-R2.

1 When asked in discovery to provide such evidence, the CLECs declined the opportunity
2 to do so.⁴⁴

3 Q: MR. DENNEY ARGUES THAT ACCESS REFORM IS A "ZERO-SUM GAME"
4 BECAUSE REDUCTIONS IN TOLL PRICES ARE REPLACED BY INCREASES
5 IN LOCAL SERVICE CHARGES AND USF CHARGES.⁴⁵ IS ACCESS REFORM
6 A ZERO SUM GAME?

7 A: No, it is not. Access reform replaces a monopoly income stream imposed on one set of
8 toll providers and their customers with an opportunity, but not the assurance, of earning
9 revenues in the competitive market via retail rates. Hence, access reform is not a zero
10 sum game because:

11 1. even if the amount of revenues ultimately flowing to local exchange companies were
12 the same before and after access reform (because the reduction in access rates exactly
13 equaled the increase in retail prices), so that it was a zero sum game *for LECs*, it
14 would *not* be a zero sum game for Arizona citizens because it would cause an
15 increase in economic efficiency and, as a result, social welfare, for all the reasons I
16 explained at length in my Direct Testimony;

17 and,

18 2. the amount of revenue ultimately flowing to LECs will not necessarily be the same
19 because it will depend on the quality of their services and their ability to compete.
20 Some LECs will benefit and others suffer from the exposure to competition. LECs
21 that are not able to attract customers in the retail market in competition with their
22 rivals will not be able to increase rates as much as those that can, and their overall
23 revenues will fall. As a result, Arizona citizens will pay less overall.⁴⁶

⁴⁴ See Joint CLECs' responses to AT&T's Data Request ATT 2-5.

⁴⁵ *Denney Reply Testimony*, p. 36.

⁴⁶ Mr. Denney's attempt to dismiss the peer-reviewed, published empirical evidence that rate rebalancing might even increase telephone penetration on the grounds that the study is "old" (it is based on 1980s data) is unavailing. While there are certainly some types of studies from which one cannot directly extrapolate to

1 **Q: DOES MR. DENNEY'S CHART AT PAGE 37 SUPPORT HIS CLAIM**
2 **THAT ACCESS REFORM IS A ZERO SUM GAME?**

3 **A:** No. Mr. Denney's sole support for his claim that access reform is a zero sum game is a
4 chart depicting annual price indices for telephone services. Even if the chart pertained
5 specifically to Arizona—which it does not—it would not show anything akin to a zero
6 sum game. The chart shows the nationwide “consumer price index” for local land-line
7 telephone service going up over time and the nationwide consumer price index for long
8 distance land-line service going down, with the nationwide price index for overall
9 “telephone service” remaining roughly constant. Mr. Denney interprets the relative
10 stability of the aggregate telephone service price index as implying that reform is a zero
11 sum game. The price index for aggregate “telephone service,” however, is not an index
12 of wireline service. It includes wireless service, which is now a prevalent form of
13 telephone service. If per-customer spending on wireless service has been going up—
14 which it has, due to data services and other new service offerings⁴⁷—the average price of
15 wireline service would have had to go down for the overall index to be roughly constant.
16 Hence, Mr. Denney's chart suggests that wireline service prices overall have been going
17 down as access reform has progressed.

current-day prices and markets, there is nothing about this study, the principles being tested, or the methodology, that would suggest that the results would not be robust to today's prices.

⁴⁷ A report from the Bureau of Labor Statistics found that annual residential expenditures for cellular phone services per consumer unit increased by 190 percent from 2001 to 2007, while expenditures for residential landline telephone and payphone services per consumer unit decreased by 30 percent. See “Consumer Expenditure Survey: Spending on Cell Phone Services Has Exceeded Spending on Residential Phone Services,” Bureau of Labor Statistics, available at <http://www.bls.gov/cex/cellphones2007.htm> (accessed March 1, 2010).

1 Q: MR. DENNEY ARGUES THAT "TECHNOLOGICAL DEVELOPMENTS" SUCH
2 AS VOIP "PROVIDE ADDITIONAL MEANS FOR AN IXC TO CONTROL
3 ITS...ACCESS COSTS."⁴⁸ DO ALTERNATIVE TECHNOLOGIES SUCH AS
4 VOIP LIMIT THE NEED FOR ACCESS REFORM?

5 A: No, they are one of the key reasons that access reform is necessary now. Mr. Denney's
6 observation that IXCs can avoid excessive access charges by switching to VoIP illustrates
7 the harms to economic efficiency of the currently distorted access regime: it distorts
8 carriers' as well as consumers' choices of technology due to access rate differences that
9 are related to arbitrary regulatory categories. Mr. Denney's suggestion that IXCs should
10 disfavor or abandon wireline circuit switched long distance technology in favor of VoIP
11 in order to avoid regulatory pricing distortions does not serve the public interest.

12 Q: MR. DENNEY CITES TO YOUR TESTIMONY AS SUPPORT FOR HIS
13 ASSERTION THAT CLECS' ACCESS RATES SHOULD BE BASED ON CLECS'
14 COST.⁴⁹ HAS HE ACCURATELY CITED YOUR TESTIMONY?

15 A: No. My testimony is that it improves social welfare to reduce ILECs' switched access
16 rates toward the ILEC's costs, and the economically supportable standard for CLEC
17 switched access rates is the rate of the competing ILEC. The former is true because if
18 switched access markets were competitive they would drive ILECs' rates toward cost,
19 and the latter is true because if switched access markets were competitive they would
20 limit CLEC rates to the rate of the competing ILEC. The testimony cited by Mr. Denney

⁴⁸ Denney Reply Testimony, pp. 14-15.

⁴⁹ Denney Reply Testimony, p. 26.

1 regarding cost pertained explicitly to ILEC rates, not CLEC rates, consistent with the
2 economic principles I just articulated.

3 **Q: MR. DENNEY ALSO ASSERTS THAT YOUR ANALYSIS PRESENTS A**
4 **"MISLEADINGLY OPTIMISTIC PICTURE OF CONSUMER BENEFITS"**
5 **BECAUSE YOU DID NOT SEPARATE RESIDENTIAL AND BUSINESS**
6 **MARKETS⁵⁰ AND THAT RESIDENTIAL LONG DISTANCE RATES**
7 **HAVE IN FACT BEEN GOING UP, NOT DOWN.⁵¹ IS HIS ANALYSIS**
8 **VALID?**

9 **A:** No. Data limitations prevented me from estimating the effects of access reform
10 separately for residential and business customers. However, his analysis in which he
11 purports to show that residential toll rates have been going up is not correct, for several
12 reasons. First, the data upon which he relies are not specific to Arizona and therefore it is
13 impossible to determine the trend of rates in Arizona from his data.

14 Second, the data series he depicts in his testimony is a price index and not actual, average
15 paid prices, and suffers from well-understood limitations of price indices. For example,
16 suppose a carrier offers pricing plan A in year 1. Then in year 2, the carrier increases the
17 prices in plan A but introduces plan B which is much less expensive. Suppose the carrier
18 even shifts most or all customers to plan B. The price index would nevertheless identify
19 only the price increase associated with A, and would not capture the price decreases
20 associated with B at all. The price indices depicted by Mr. Denney are calculated by

⁵⁰ Denney Reply Testimony, pp. 36 and 38.

⁵¹ Denney Reply Testimony, pp. 38-40.

1 following base-year pricing plans and do not adjust for alternative offerings that are
2 introduced in years between revisions to the base assumptions (and do not true-up when
3 the base is adjusted).

4 Third, the price indices presented by Mr. Denney are nominal prices, not real (i.e.,
5 inflation-adjusted) prices. Since 2003, the nominal price index for residential intrastate
6 toll service went up by 14 percent, but inflation was 17 percent, so that real prices for
7 residential long distance service fell, even according to the index methodology.⁵²

8 **Q: MR. DENNEY SAYS YOUR ANALYSIS DOESN'T TAKE INTO**
9 **ACCOUNT "THE MANNER IN WHICH AT&T SETS ITS LONG**
10 **DISTANCE PRICING" BECAUSE AT&T ENGAGES IN "UNIFORM**

⁵² "Universal Service Monitoring Report, CC Docket No. 98-202," Federal and State Staff for the Federal-State Joint Board on Universal Service in CC Docket No. 96-45, 2009 (Data Received through August 2009), Table 7.5, and Bureau of Labor Statistics, Consumer Price Index and Producer Price Index Industry data. Mr. Denney states as an aside at footnote 105 of his testimony that Figure 5 of my Direct Testimony must have an error, because the figure shows the average revenue per minute for interstate long distance service falling in 2006 relative to 2005. This is not an error. The figures I showed are interstate toll rates including access fees and excluding universal service. My methodology for calculating these rates from the FCC tables was fully documented in my workpapers provided in discovery. In Mr. Denney's defense, however, although the methodology was fully documented, my figure in the testimony itself did contain a typo in the labeling, which should have said "Long Distance ARPM (Including Access Cost and Excluding Universal Service Cost)" instead of "Long Distance ARPM (Including Access and Universal Service Cost)." Mr. Denney also states that according to a different FCC report, interstate ARPM went up in 2007. The FCC report upon which I relied had data only through 2006, and one cannot mix and match the FCC's time series. For example, the data in the Monitoring Report, which is the report Mr. Denney references for his 2007 figure, shows rates *falling* between 2005 and 2006 for interstate calls, which is precisely the point that Mr. Denney was disputing. In any event, I would also note that all of these reports round the ARPMs to the whole cent, and the differences between the specific numbers we are talking about are one cent, so the differences Mr. Denney is focusing on are likely to be artifacts of rounding. I also note that looking at all the different versions of time series available from the FCC, they all show the same pattern of retail interstate toll prices declining in step with interstate access rates.

1 **(ACROSS STATES) PRICING.”⁵³ IS IT TRUE THAT YOUR ANALYSIS**
2 **DOES NOT TAKE THIS INTO ACCOUNT?**

3 A: No, this is not true. On the contrary, my analysis fully takes into account the explicit and
4 implicit similarities and differences in AT&T’s pricing policies across states.⁵⁴ Rather
5 than assuming that customers pay the same rates in each state, I allow the data to tell me
6 whether they do or not. I calculate the prices that customers pay by calculating the
7 average per minute revenue. This takes into account not only the “rack rate” prices
8 available in the market, but also discounted pricing plans, grandfathered plans, add-on
9 plans, and other offerings. It also takes into account the fact that AT&T offers a menu of
10 plans, but may vary its marketing strategy in some states to encourage some plans over
11 others, or promote some discount plans more heavily in some states relative to others. As
12 I explained in my Reply Testimony, there are many reasons that per-minute revenues
13 may vary from state to state, and my methodology permits those differences to be
14 captured in the analysis.

⁵³ *Denney Reply Testimony*, pp. 40-41.

⁵⁴ Other than the ISCF, which is not included in my regression analysis upon which I reported in my Direct Testimony. Exclusion of the ISCF from the analysis means that the regression captures the effect of access rate differences on the actual revenues earned by AT&T from its menu of available pricing plans excluding ISCF revenues, and I would expect the effect on consumers of reduced access rates to be greater than the effect measured by my regression analysis.

1 **Q: ARE AT&T'S PRICING PLANS IN FACT UNIFORM ACROSS STATES?**

2 **A:** No. Dr. Oyefusi explains in his testimony that a number of AT&T's residential and
3 business retail rate plans, including, for example, AT&T's residential Basic Rate Plan
4 prices, are not the same from state to state.⁵⁵

5 **Q: MR. DENNEY SAYS YOUR DATA ARE "APPROPRIATE IN AN**
6 **ACADEMIC STUDY" BUT "TOO BROAD" FOR THIS CASE.⁵⁶ PLEASE**
7 **COMMENT.**

8 **A:** Data are suitable for an academic study if they are accurate, unbiased, and as complete as
9 possible. Mr. Denney's suggestion that the same qualifications would not apply to data
10 analysis upon which this Commission is being asked to rely is profoundly incorrect and, I
11 believe, insulting to the Commission. The data I used were proper for the use to which I
12 put them, which was to use accepted statistical techniques to estimate the relationship
13 evidenced across all states and several years between access rates and toll prices. Mr.
14 Denney's suggestion that some data points should be thrown out because they do not
15 conform to his predetermined conclusions is improper, reflects a misunderstanding of
16 statistical inference, and does not follow any accepted research methodology of which I
17 am aware (nor does he cite to any). Any conclusions drawn from such a truncated

⁵⁵ Rejoinder Testimony of Dr. Ola Oyefusi on Behalf of AT&T Communications of the Mountain States, Inc. and TCG Phoenix, *In the Matter of the Review and Possible Revision of Arizona Universal Service Fund Rules, Article 12 of the Arizona Administrative Code and In the Matter of the Investigation of the Cost of Telecommunications Access*, Before the Arizona Corporation Commission, Docket Nos. RT-00000H-97-0137 and T-00000D-00-0672, March 5, 2010.

⁵⁶ *Denney Reply Testimony*, pp. 41-43.

1 sample would suffer from a variety of statistical defects, including bias. Nothing in Mr.
2 Denney's comments, therefore, calls into question the validity of my research
3 methodology or statistical techniques, nor of my conclusion that the access reform
4 proposed by AT&T in Arizona would be expected to result in average retail intrastate toll
5 price reductions of 19 to 42 percent.⁵⁷

6 Q: MR. DENNEY CLAIMS THAT [BEGIN HIGHLY CONFIDENTIAL
7 INFORMATION] [REDACTED] [END HIGHLY
8 CONFIDENTIAL INFORMATION] HAS INTRASTATE ACCESS RATES
9 AS LOW AS AT&T'S PROPOSAL.⁵⁸ PLEASE COMMENT.

10 A: Mr. Denney is mistaken. First of all, AT&T's average per minute interstate access cost is
11 well within the range of *interstate* access rates across the 50 states, which is the relevant
12 fact. By "AT&T's proposal," he means AT&T's interstate average expense in Arizona,
13 which is [BEGIN HIGHLY CONFIDENTIAL INFORMATION] [REDACTED] [END
14 HIGHLY CONFIDENTIAL INFORMATION] cents. But [BEGIN HIGHLY
15 CONFIDENTIAL INFORMATION] [REDACTED] [END HIGHLY CONFIDENTIAL
16 INFORMATION] cents is not a particularly low value when compared to the other
17 interstate access rates. About 44 percent of the observations in this data set are between
18 [BEGIN HIGHLY CONFIDENTIAL INFORMATION] [REDACTED] [END HIGHLY
19 CONFIDENTIAL INFORMATION] cents and [BEGIN HIGHLY

⁵⁷ Aron Direct Testimony, p. 65.

⁵⁸ Denney Reply Testimony, p. 42.

1 **CONFIDENTIAL INFORMATION** ■ **[END HIGHLY CONFIDENTIAL**

2 **INFORMATION]** cents. Hence, AT&T's proposal is to reduce intrastate rates in
3 Arizona to a level that is consistent with a large fraction of interstate rates across the
4 country.

5 Second, Mr. Denney's assertion is factually incorrect. He has ignored the fact that in just
6 the last eight months both New Jersey and Massachusetts have ordered intrastate rates
7 lowered to interstate levels, and both of those states have interstate levels significantly
8 *lower* than those in Arizona. In fact, the recent access reform order in Massachusetts
9 applied to CLECs only; Verizon (the major ILEC in Massachusetts) has been mirroring
10 its interstate rate in Massachusetts since 2002.⁵⁹ Hence, not only is Mr. Denney incorrect
11 that "not a single state has intrastate access rates as low as AT&T's proposal," Verizon
12 itself has been charging intrastate rates in Massachusetts that are below the rates AT&T is
13 proposing in Arizona.

14 Finally, I note that the numbers reveal that the need for access reform is particularly acute
15 in Arizona. The average intrastate rates in Arizona are nearly **[BEGIN HIGHLY**

16 **CONFIDENTIAL INFORMATION** ■ **[END HIGHLY CONFIDENTIAL**

⁵⁹ Final Order, *In the matter of Petition of Verizon New England, Inc., MCI metro Access Transmission Services of Massachusetts, Inc., d/b/a Verizon Access Transmission Services, MCI Communications Services, Inc., d/b/a Verizon Business Services, Bell Atlantic Communications, Inc., d/b/a Verizon Long Distance, and Verizon Select Services, Inc. for Investigation under Chapter 159, Section 14, of the Intrastate Access Rates of Competitive Local Exchange Carriers*, before the Commonwealth of Massachusetts department of Telecommunications and Cable, D.T.C. 07-9, June 22, 2009, p. 6.

Arizona Corporation Commission
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Rejoinder Testimony of Dr. Debra J. Aron

1 **INFORMATION]** times the average interstate rates in the state, a difference that is
2 among the highest in the country.

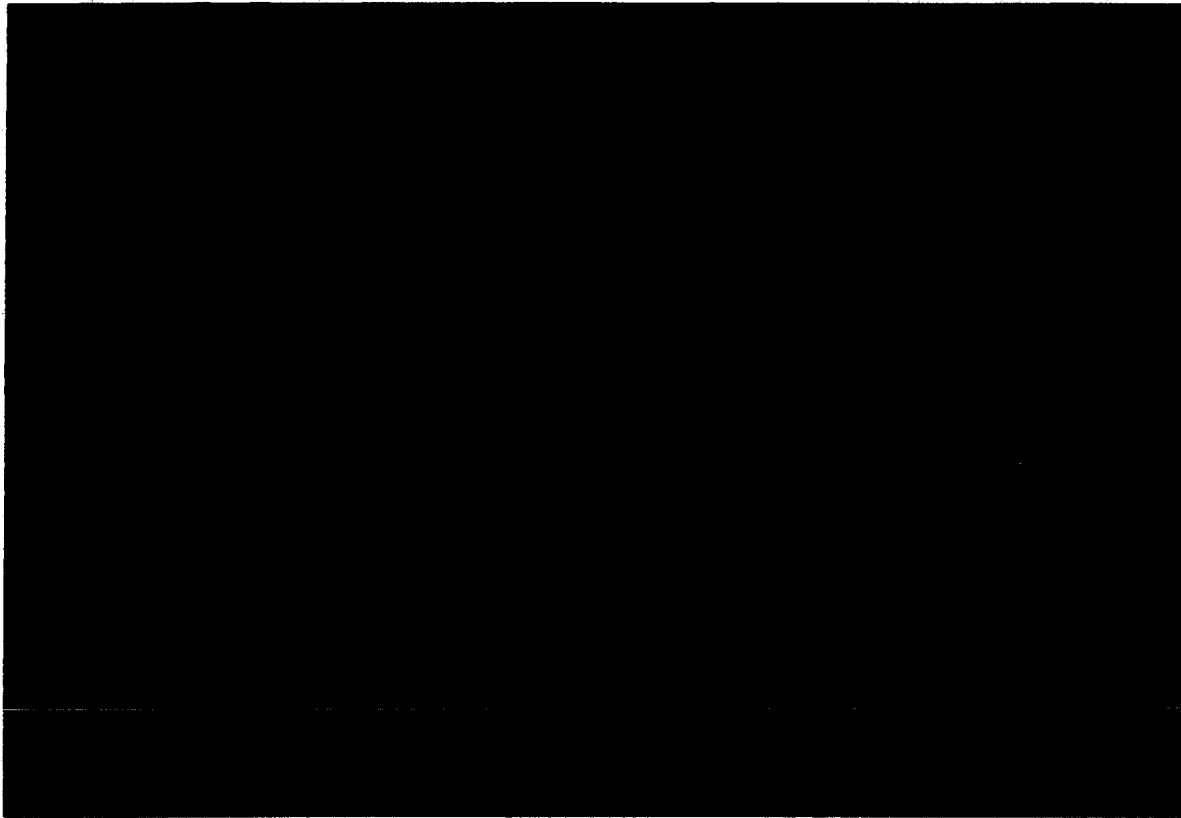
3 **Q: DOES THIS COMPLETE YOUR REJOINDER TESTIMONY?**

4 **A: Yes, it does.**

Figure 1

Average Charges for Call Termination Services in Arizona

[BEGIN HIGHLY CONFIDENTIAL INFORMATION]



[END HIGHLY CONFIDENTIAL INFORMATION]

**EXHIBIT 2:
RESPONSES TO MR. DENNEY'S ARGUMENTS**

Denney argument	Denney Reply page numbers	Aron response	Aron page numbers
The comparison of interstate and intrastate rates is not "apples-to-apples" because the interstate rate should include the SLC	pp. 3, 21-22	The SLC is not an access rate: it is charged to end-user customers and was created so that the associated revenues would be removed from intercarrier access. The analog in the intrastate jurisdiction of removing implicit subsidies from the access rates and recovering them through a SLC would be to reduce the intrastate access rates and recover the forgone revenues through opportunities for increased retail prices for local exchange service	Reply, pp. 90-92 Rejoinder, pp. 21-22
Benchmarking CLEC rates to any level other than CLECs' cost is arbitrary	pp. 4, 21-30	CLECs' rates should be capped at the ILEC level because in a competitive marketplace, CLECs would not be permitted to charge a rate higher than that of the incumbent with whom it competes	Direct, pp. 86-87 Reply, pp. 23-30 Rejoinder, p. 23
Originating access is not a monopoly service because vertically integrated providers could avoid access rates entirely	pp. 5, 12-14	All LECs have market power in originating access If integrated providers could create enough market discipline, CLECs' originating rates would be at least as low as the ILEC's, which they are not	Reply, pp. 18-22 Rejoinder, pp. 23-27

**EXHIBIT 2:
RESPONSES TO MR. DENNEY'S ARGUMENTS**

Denney argument	Denney Reply page numbers	Aron response	Aron page numbers
Reductions in access should be gradual because CLECs need time to adjust their business plans and contracts	pp. 5, 30-34	CLECs have known since 1996 that their intrastate access rates were subject to reductions by regulators and have advised investors of this risk. Consumers should not be made to wait for the benefits of access reform because or if CLECs have not modified their business plan in anticipation of this event	Reply, pp. 32-35, 50-53, and Exhibit DJA-R2
Most CLECs were entering the market around 1999 and therefore would have considered Qwest's access rates at that time when deciding whether to enter	pp. 29-30	The CLECs have provided no evidence that they entered around 1999, nor that they considered Qwest's access rates when they entered. They refused to provide any such evidence in discovery. In addition, the CLECs have been advising their investors since at least 1997 that access rates were subject to reductions	Reply pp. 31-34, Exhibit DJA-R2, Aron Rejoinder, pp. 29-30
CLECs' access rates are (purportedly) similar to rates Qwest charged in 1999, so CLECs do not have market power	pp. 8-9, 29-30	Current CLEC access rates are higher than Qwest's current rates. The fact that CLECs have not reduced their rates in tandem with Qwest's demonstrates market power. A competitive market would not permit a competitor to charge a price that is higher than that of the incumbent	Direct, pp. 10, 36, 39 Reply, pp. 21-23, 31-34
The FCC's argument that it is unfair for CLECs to shift their expenses to IXC does not apply because CLEC rates are not excessive	pp. 9-10	CLEC rates are excessive because they are higher than the incumbents' and they are higher than their own interstate rates	Direct, pp. 10, 36, 39 Reply, pp. 21-25

**EXHIBIT 2:
RESPONSES TO MR. DENNEY'S ARGUMENTS**

Denney argument	Denney Reply page numbers	Aron response	Aron page numbers
CLECs' rates are not excessive because if CLECs had market power their rates would be even higher.	p. 10	CLEC rates are excessive because they are higher than the incumbents' and they are higher than their own interstate rates. Even a monopolist does not charge an infinite rate	Direct, pp. 10, 36, 39 Reply, pp. 21-25
It does not matter for purposes of assessing CLECs' market power that IXCs do not have a choice at the very instance of the call	p. 12	This is a straw man. The analysis of market power is fully articulated in Aron's reply	Reply, pp. 11-19
Access distortions are less of a problem because IXCs can avoid access rates by using VoIP technology	pp. 14-15	This observation illustrates the distortions caused by the current access regime. Abandoning wireline circuit switched long distance technology in favor of VoIP in order to avoid excessive charges caused by regulation does not serve the public interest	Rejoinder, p. 32
AT&T's proposal is a "double standard" because it seeks to have CLECs alone shoulder the burden of varying long distance and access costs across all participants by denying them adequate compensation for switched access services rendered	p. 16	CLECs are not denied adequate compensation under AT&T's plan unless they are too inefficient to compete in the retail market	Reply, pp. 40-41, 47 Rejoinder, p. 29
The local loop is a "joint cost" that should be partially recovered in access rates	p. 23	The argument that IXCs are cost-causers of the costs of the loop has long been rejected by the FCC and economists. It is equivalent to arguing that IXCs are cost-causers of the cost of a telephone handset and should subsidize handset manufacturers	Reply, pp. 36-38

**EXHIBIT 2:
RESPONSES TO MR. DENNEY'S ARGUMENTS**

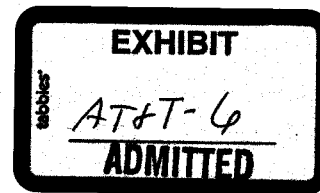
Denney argument	Denney Reply page numbers	Aron response	Aron page numbers
Reciprocal compensation rates are not a good benchmark for CLEC and RLEC access rates because it is 2-way traffic and access is one-way traffic	p. 25	No response necessary; argument has no apparent content. Access service and reciprocal compensation are the same functionality, as acknowledged by Qwest, Verizon and the CLECs in discovery	Rejoinder, p. 28
Reciprocal compensation rates are not a good benchmark for CLEC and RLEC access rates because the costs are different	pp. 25-26	Access service and reciprocal compensation are the same functionality, as acknowledged by Qwest, Verizon and the CLECs in discovery Federal rules require CLECs to charge reciprocal compensation rates based on the ILECs' costs, unless they can demonstrate their own costs are higher. No CLEC has claimed or shown that they ever demonstrated this in Arizona	Direct, pp. 84-86 Rejoinder, p. 28
Some other states allow CLECs to modify the benchmark by demonstrating cost justification	pp. 26-27	CLECs have not been able to identify a single state in which a CLEC has in fact justified higher costs	Reply, pp. 26-28
California allowed a benchmark at 10% above ILEC rates	pp. 26-27	There was no showing in California that CLECs' access costs were higher than ILECs' costs. There has also been no showing in this case that CLECs' cost are higher than ILECs' costs, so any such benchmark would be arbitrary	Reply, pp. 26-28 Rejoinder, p. 20
CLECs cannot compete with Qwest if they have to charge the same access rates and same retail rates	pp. 31-32	If CLECs cannot compete with Qwest by charging the same access and retail rates as Qwest, then they are inefficient. They should not be rewarded for being inefficient	Reply, pp. 40-41, 47 Rejoinder, p. 29

**EXHIBIT 2:
RESPONSES TO MR. DENNEY'S ARGUMENTS**

Denney argument	Denney Reply page numbers	Aron response	Aron page numbers
CLECs "typically" have long-term contracts with their customers and therefore may not be able to immediately increase end-user prices to compensate for lost access revenues	p. 32	According to the information provided by Mr. Denney, at least approximately half of the customers currently under contract will have rolled off within two years. This proceeding has been preceded by two years of workshops and industry discussion, so that most CLEC customers will have already rolled off of any contracts they entered into before this process began in Arizona	Reply, pp. 52-53
Access rate reductions do not help consumers because it is a zero sum game	pp. 36-38	Access reform is not a zero sum game because it would cause an increase in economic efficiency and social welfare and Arizona consumers will pay less overall if access rates are reduced In addition, the evidence provided by Mr. Denney does not support this argument	Rejoinder, pp. 30-31
Dr. Aron's analysis of the benefits of access reform for customers is flawed because she does not separate residential from business markets, and residential prices have been going up	pp. 38-40	Residential prices have not been going up. Moreover, if anything, the analysis understates the consumer benefits of access reform because it does not take into account the additional effect of eliminating the ISCF	Rejoinder, pp. 33-35
Dr. Aron doesn't account for the across-states uniform manner in which AT&T sets its long distance pricing	pp. 40-41	This is incorrect. Long distance rates across states can vary for many reasons, and the analysis captures these differences	Reply, pp. 86-88 Rejoinder, pp. 34-36

**EXHIBIT 2:
RESPONSES TO MR. DENNEY'S ARGUMENTS**

Denney argument	Denney Reply page numbers	Aron response	Aron page numbers
The data upon which Dr. Aron relies for forecasting toll price reductions is inappropriate	pp. 41-43	The data are appropriate for their use. It would be incorrect and counter to accepted research methods to truncate the data as Mr. Denney suggests	Rejoinder, pp. 36-37
Dr. Aron's projected savings for toll customers from the proposed access reductions are highly doubtful	pp. 43-44	Mr. Denney has not provided any evidence that the empirical analysis showing that the proposed access reform would lead to lower toll prices is invalid	Rejoinder, pp. 36-39



BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS

KRISTIN K. MAYES, Chairman
GARY PIERCE
PAUL NEWMAN
SANDRA D. KENNEDY
BOB STUMP

IN THE MATTER OF THE REVIEW AND
POSSIBLE REVISION OF ARIZONA UNIVERSAL
SERVICE FUND RULES, ARTICLE 12 OF THE
ARIZONA ADMINISTRATIVE CODE.

Docket No. RT-00000H-97-0137

IN THE MATTER OF THE INVESTIGATION OF
THE COST OF TELECOMMUNICATIONS
ACCESS.


Docket No. T-00000D-00-0672

**NOTICE OF FILING ERRATA
REGARDING TESTIMONY OF
DR. ARON**

AT&T Communications of the Mountain States, Inc. and TCG Phoenix give notice of the
filing of the attached errata sheets making minor corrections to the Direct, Reply and Rejoinder
Testimonies of Dr. Debra J. Aron. The substance of Dr. Aron's testimonies is unaffected by
these corrections.

RESPECTFULLY SUBMITTED this 11th day of March, 2010.

GALLAGHER & KENNEDY, P.A.

By 
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Attorneys for AT&T Communications of the
Mountain States, Inc. and TCG Phoenix

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2 foregoing filed this 11th day of
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Phoenix, Arizona 85007

6 **Copies** of the foregoing mailed
7 this 11th day of March, 2010, to:

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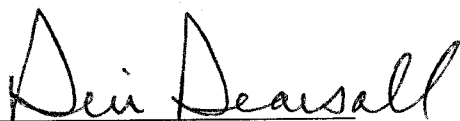
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ERRATA TO
DIRECT TESTIMONY OF DEBRA J. ARON ON BEHALF OF AT&T
COMMUNICATIONS OF THE MOUNTAIN STATES, INC. AND TCG PHOENIX
Docket No. RT-00000H-97-0137
Docket No. T-00000D-00-0672

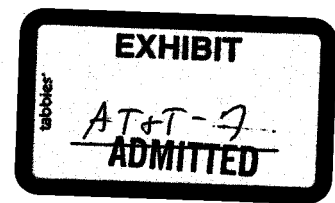
Citation	Change
Page 42, lines 5-6	For additional perspective, there are 93 separate <u>rate centers</u> local calling areas that lie within the Phoenix MTA
Page 48, footnote 49	⁴⁹ NEV. ADMIN. CODE ch. 704 § 704. <u>75295 6898</u> ; also § 704. <u>68048 68952</u> .
Page 52, lines 5-7	These states include Alaska, ⁶¹ Louisiana, ⁶² Maine, ⁶³ Maryland, ⁶⁴ Massachusetts, ⁶⁵ Missouri, ⁶⁶ New Hampshire, ⁶⁷ New Mexico, ⁶⁸ New York, ⁶⁹ Ohio, ⁷⁰ Pennsylvania, ⁷¹ Texas, ⁷² Virginia, ⁷³ and Washington. ⁷⁴
Page 52, footnote 63	⁶³ CODE ME. R. 65-407 Ch. 280 §§ 2J, 8B.
Page 52, footnote 68	⁶⁸ N.M. ADMIN. CODE at 17.11.10.8.C; at 17.11.10.7.R; and at 17.11.10.2.
Page 53, lines 1-3	In addition, some states have a policy constraining access rates that applies equally to CLECs and ILECs. Examples of such states are Maine <u>and New Mexico</u> , where all carriers are required to mirror their own interstate access rates; ⁷⁵ Connecticut, where the DPUC ordered all carriers to cap their intrastate access rates at 1.5¢ per minute; ⁷⁶ and Indiana, where intrastate access rates for all carriers are considered just and reasonable if they mirror interstate rates. ⁷⁷
Page 53, footnote 75	⁷⁵ CODE ME. R. 65-407 Ch. 280 §§ 2J, 8B, and N.M. ADMIN. CODE at 17.11.10.8.C; at 17.11.10.7.R; and at 17.11.10.2.
Page 59, Legend of Figure 5	Long Distance Interstate ARPM (Including Access and <u>excluding</u> Universal Service Cost)
Pages 82-83, footnote 94	⁹⁴ See, for example, Mark Armstrong, "The Theory of Access Pricing and Interconnection," in <i>Handbook of Telecommunications Economics</i> , ed. M.E. Cave et al., Vol.1, (Amsterdam: Elsevier Science B. V., 2002), pp. 356-379, and sources cited therein. In addition, some economists argue that the efficient interconnection price is zero (i.e., "bill and keep"). See, e.g., Patrick DeGraba, "Bill and Keep at the Central Office as the Efficient Interconnection Regime," Federal Communications Commission, OPP Working Paper No. 33, (Dec. 2000) ¶ <u>42</u> , n. 3 and citations in Appendix C to the <i>Intercarrier Compensation Reform FNPRM</i> .

ERRATA TO
REPLY TESTIMONY OF DEBRA J. ARON ON BEHALF OF AT&T
COMMUNICATIONS OF THE MOUNTAIN STATES, INC. AND TCG PHOENIX
Docket No. RT-00000H-97-0137
Docket No. T-00000D-00-0672

Citation	Change
Page 44, lines 15-17	• Public Notice in CC Docket No. 01-92, released <u>September 30</u> October 18 , 2002 (seeking comment on two petitions that request rulings regarding the intercarrier compensation regime applicable to certain types of wireless traffic)
Page 41, footnote 53	⁵³ Denney Direct Testimony, p. <u>41</u> 42 .
Page 80, footnote 137	¹³⁷ <i>Johnson Direct Testimony</i> , p. <u>7</u> 9 .

ERRATA TO
REJOINDER TESTIMONY OF DEBRA J. ARON ON BEHALF OF AT&T
COMMUNICATIONS OF THE MOUNTAIN STATES, INC. AND TCG PHOENIX
Docket No. RT-00000H-97-0137
Docket No. T-00000D-00-0672

Citation	Change
Page 21, lines 6-10	Rather than reiterate these arguments, I have prepared a table, attached as Exhibit DJA-Rejoinder 2, that lists each of the arguments in Mr. Denney's Reply Testimony and points the Commission to my response to each argument in my Direct and/or Reply testimonies (and/or, in some cases, to Dr. Oyefusi's testimony).
Page 18, footnote 15	¹⁵ Georgia (all ILECs), Indiana (major ILEC and rural ILECs), <u>Illinois (all ILECs)</u> , Kansas (all ILECs), Kentucky (major ILEC), Michigan (all ILECs), Nevada (major ILECs), Wisconsin (major ILEC), Mississippi (major ILEC), Tennessee (major ILEC), West Virginia (major ILEC), Ohio (all LECs), Texas (ILECs with over <u>3 4</u> million lines and CLECs), Maine (all LECs), New Mexico (all LECs), Massachusetts (major ILEC and CLECs), and New Jersey (all LECs).
Page 18, footnote 17	¹⁷ In addition, Mr. Price is incorrect in his characterization of the Wisconsin statute. The Wisconsin statute requires all price regulated LECs to reduce their intrastate rates to interstate levels, not just price-regulated carriers with over 150,000 lines. The statute provides a longer timeline for carriers with fewer than 150,000 lines to reduce their intrastate rates to their interstate levels, and <u>may does</u> not require those carriers to reduce their CCL all the way to zero.



BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS
KRISTIN K. MAYES - Chairman
GARY PIERCE
PAUL NEWMAN
SANDRA D. KENNEDY
BOB STUMP

IN THE MATTER OF

THE REVIEW AND POSSIBLE
REVISION OF ARIZONA
UNIVERSAL SERVICE FUND
RULES, ARTICLE 12 OF THE
ARIZONA ADMINISTRATIVE
CODE.

DOCKET NO. RT-00000H-97-0137

IN THE MATTER OF THE
INVESTIGATION OF THE COST OF
TELECOMMUNICATIONS ACCESS.

DOCKET NO. T-00000D-00-0672

DIRECT TESTIMONY OF

DR. OLA OYEFUSI

On Behalf of

AT&T Communications of the Mountain States, Inc. and TCG Phoenix

PUBLIC VERSION

December 1, 2009

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OA0_Exhibit A	List of Testimonies by Dr. Ola Oyefusi
OA0_Exhibit B	Arizona Access Rates – Carrier Common Line
OA0_Exhibit C	Verizon’s and Citizen’s Access Rates - Charts
OA0_Exhibit D	[Highly Confidential Exhibit] IXC Intrastate vs Interstate Access Payments
OA0_Exhibit E	AT&T 10/27/09 Letter to Waxman, Boucher & Stupak
OA0_Exhibit F	States with Intrastate/Interstate Access Parity

INTRODUCTION - WITNESS QUALIFICATIONS AND PURPOSE

1
2
3 **Q. DR. OYEFUSI, PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.**

4
5 **A.** My name is Ola A. Oyefusi, and my business address is 7125 Columbia Gateway Drive,
6 Columbia, Maryland 21046.

7 **Q. DR. OYEFUSI, BY WHOM ARE YOU EMPLOYED AND IN WHAT**
8 **CAPACITY?**

9
10 **A.** I am a Lead Carrier Relations Manager in AT&T's National Access Management
11 Organization. In that capacity, I am responsible for all matters affecting AT&T's costs to
12 interconnect its network with those of all other carriers, regardless of class of service or
13 technology, in twenty-six states.

14 **Q. DR. OYEFUSI, PLEASE DESCRIBE YOUR EDUCATIONAL BACKGROUND**
15 **AND PROFESSIONAL EXPERIENCE.**

16
17 **A.** I hold a Ph.D. in Economics from George Mason University in Fairfax, Virginia.
18 Additionally, I hold M.A. and B.S. degrees in Economics from Morgan State University
19 in Baltimore, Maryland.

20 I began my career with AT&T in 1999 and have been responsible for matters related to
21 AT&T's access and local interconnection expenses since then. Among other duties, I am
22 responsible for reviewing and interpreting access tariffs and managing AT&T's
23 wholesale costs of providing long distance service.

24 Prior to joining AT&T, from 1991 until 1999, I was employed by the Public Service
25 Commission of the District of Columbia as an economist and Commission advisor. In
26 those capacities, I reviewed and analyzed rate filings submitted by telecommunications

1 and energy companies. I also prepared revenue and cost analyses to support testimony
2 and comments on issues affecting the telecommunications and energy industries. Before
3 that, I have taught economics and held research positions, between 1985 through 1991, at
4 George Mason University's Center for Study of Public Choice and at Morgan State
5 University.

6 **Q. DR. OYEFUSI, PLEASE BRIEFLY SUMMARIZE YOUR RECENT**
7 **EXPERIENCE IN ACCESS CHARGE PROCEEDINGS.**

8
9 **A.** I recently testified in New Jersey regarding access reform in a proceeding similar to this
10 one. I have been actively involved on issues related to access charges in several other
11 states. I testified on AT&T's behalf in switched access charge proceedings in New
12 Hampshire, Massachusetts, Virginia, and Pennsylvania, and I am currently preparing
13 testimony for an Illinois proceeding investigating the access charges of CLECs, some of
14 which are involved in this case. I generally provided economic support for access
15 complaints or interventions by AT&T in all states. I have also developed presentations
16 on forward-looking economic costs in state proceedings to establish rates for unbundled
17 access. A list of the proceedings in which I have been a witness is attached as
18 OAO_Exhibit A.

19 While I was at the District of Columbia Public Service Commission ("DC PSC"), I
20 provided economic advice in a 1997 unbundled access proceeding involving Verizon
21 DC's predecessor, Bell Atlantic-Washington, D.C., Inc. I also reviewed and interpreted
22 tariff applications involving revisions of existing services and the introduction of new
23 services submitted by Verizon DC and provided recommendations to the Commissioners.
24 Prior to 1997, I provided written and oral testimony on behalf of the District of Columbia

1 PSC Staff in rate cases involving Potomac Electric Power Company and Verizon DC's
2 earlier predecessor, the Chesapeake and Potomac Telephone Company.

3 **Q. PLEASE SUMMARIZE YOUR TESTIMONY.**

4 **A.** My testimony addresses Issues 1 through 12 in the procedural order of September 29,
5 2009. In summary, I will explain why the Commission should (i) reduce the intrastate
6 switched access rates of all Arizona incumbent local exchange carriers ("ILECs") to
7 parity with their corresponding interstate switched access rates, (ii) cap the switched
8 access rates of any CLEC operating in an ILEC's service territory at that same ILEC's
9 interstate level, and (iii) allow carriers to recover the reductions in access revenue
10 through flexibility in retail rates and, if necessary, in limited circumstances through
11 universal service support.

12 I will also explain that since 1984, intrastate access charges paid by long distance
13 interexchange carriers ("IXCs") without exception to local exchange carriers have
14 remained at exceedingly high levels in order to maintain the historic subsidy flow from
15 long distance consumers to support local exchange service below cost. And because
16 access charges are a principal component of the cost to provide wireline long-distance
17 service, high access charges force wireline interexchange carriers ("IXCs") to maintain
18 higher retail prices for long-distance service. This forces consumers of wireline long
19 distance service across the state to pay more for long distance, in order to subsidize lower
20 local service rates for consumers in some areas.

21 While economists and policy makers have debated for twenty-five years whether
22 the arrangement of implicit subsidies in access helped consumers, there is now general
23 agreement that such implicit subsidies cannot be maintained in today's highly

1 competitive telecommunications market. The intrastate switched access rates in effect
2 today still reflect monopoly-era thinking, when wireline long distance rates were set far
3 in excess of cost in order to subsidize basic local telephone service, and consumers who
4 wished to communicate over long distances had no real choice other than to pay the high
5 long-distance rates. Today, Arizona consumers have a broad range of options for their
6 in-state long distance communications, including wireless carriers, e-mail, social
7 networking websites, and VoIP providers – none of which pay subsidy-laden intrastate
8 access charges in the same manner as wireline IXC's like AT&T.

9 As things now stand, intrastate access charges as high as 13¢ per minute are being
10 imposed almost exclusively on long distance interexchange carriers such as AT&T, while
11 competing means of communications are generally able to complete their calls for as
12 little as 7/100ths of a cent per minute (\$0.0007) (or in some cases, nothing) because
13 federal law and the FCC have established very low call completion rates *for every other*
14 *type of traffic except intrastate switched access*. The charts included later in this
15 testimony graphically underscore the point.

16 Not surprisingly, the regulatory-driven rate disparities for competing services are
17 driving customers *away* from traditional wireline long distance and *toward* substitute
18 services not saddled with the access cost burden. For example, parents use Skype or
19 Vonage to stay in touch with kids in college. Text messaging is replacing voice calling,
20 particularly among those under 30. As of June 2008, Arizona had almost 5 million
21 wireless subscribers, which means that 76 percent of all Arizona residents – that is
22 *residents*, not households – now have a wireless phone. Even more striking, 97 percent

1 of Arizonans over the age of 15 (i.e. excluding children below the high school age) have
2 a wireless phone.

3 When one segment of the market is singled out and forced to incur subsidy
4 obligations that its competitors do not face, the results are predictable. Arizona
5 consumers are using traditional wireline long distance less, in part because they perceive
6 it to be overpriced relative to other options not saddled with the access subsidy
7 obligations. It was one thing to impose subsidy obligations on a single segment of the
8 communications industry – IXC's – when consumers had no other choice but to use those
9 IXC's. However, it is quite another thing today, when IXC's are only one of many
10 communications options available to consumers, to force IXC's to bear subsidy
11 obligations their competitors do not face. Clearly, that needs to change.

12 AT&T and other wireline IXC's cannot compete effectively when they must pay
13 intrastate switched access rates as high as 13 cents per minute and their competitors
14 generally do not. This disparity in pricing has discouraged some consumers from using
15 the traditional wireline network for their long distance calling, a fact underscored by the
16 **[BEGIN CONFIDENTIAL INFORMATION] [REDACTED] [END CONFIDENTIAL**
17 **INFORMATION]** drop in Qwest's intrastate access minutes in just the last two years.¹

18 As I explain in my Testimony, the first step in eliminating anti-competitive
19 subsidies from the LECs' intrastate switched access charges is to reduce those rates to
20 parity with the LECs' interstate switched access charges. Those interstate rates are more
21 than compensatory, and will continue to provide contribution to the LECs' joint and

¹ See Qwest Response to Staff Data Request STF 01-001 and STF 01-002.

1 common costs. Also, the interstate rates are much higher than the cost-based rates that
2 the LECs charge for the materially identical function of local call termination.

3 Approximately 33 states have adopted some type of reform to intrastate switched
4 access rates, and more than 20 have taken steps similar to the straightforward approach
5 that AT&T recommends here: to order reduction of (or to begin the process of reducing)
6 ILECs intrastate switched access rates to levels at or below their interstate switched
7 access rates.² Those states have recognized, as the Commission should here, that high
8 access charges harm consumers by driving long-distance prices higher and by preventing
9 wireline IXC's from competing fully and fairly for their business. And as some of these
10 other states have done, the Commission should allow incumbent local exchange carriers
11 the opportunity to rebalance the amount of revenue reductions through a combination of
12 rate flexibility for retail local service and through modifications to the existing Arizona
13 universal service fund. Essentially, ILECs would have the opportunity to recover more
14 of their local service costs from local service rates or from explicit, broadly funded
15 universal service subsidies, rather than implicit subsidies in wholesale access rates that
16 apply to only one group of competing providers. That way, the customers who caused
17 the local exchange carriers to incur local service costs will be asked to pay for them, not
18 the captive access service customers (the IXC's). The Commission can then rely on
19 competition to constrain rates for all services.

20 As I describe below, there is a simple way to implement meaningful access charge
21 reforms, allow carriers to recover the reductions in revenue, and keep local service rates

² When other types of access reform, besides ILECs parity, are considered (e.g. with some other form of constraints on ILECs and CLECs) the number of states with reform increases to about 33. See Dr. Aron's Direct Testimony at Section V(C).

1 at reasonable levels. The Commission should first require all LECs to reduce their
2 intrastate switched access rates to parity with the corresponding interstate rates, and at the
3 same time it should give ILECs the flexibility, but not a mandate, to increase rates up to a
4 reasonable benchmark level (subject to reasonable limits on annual rate increases during
5 a transition period). To the extent that the allowed rate increases are not sufficient to
6 recover the reductions in access revenues, an ILEC will be allowed to obtain explicit
7 subsidies from the AUSF. As I show below, Qwest has proposed benchmarking methods
8 that would yield a benchmark of about \$16.50, which is quite reasonable, and in fact
9 represent the low end of a reasonable range of possible benchmarks. In fact, setting a
10 benchmark of \$18 would still leave most ILECs' local service rates at about the same
11 level, in real inflation-adjusted terms, as when the Commission last fixed those rates,
12 while balancing off most of the access rate reductions proposed here and thereby
13 minimize the level of additional AUSF support contribution.

14 In short, my Testimony will show that the LECs' intrastate access rates can no
15 longer be deemed just, reasonable or non-discriminatory. I will show that reducing those
16 rates will benefit consumers in multiple ways by allowing the competitive market to work
17 with fewer artificial regulatory distortions. The current system simply cannot be
18 sustained, as ALECA members have recognized in their whitepaper³, and as consumers
19 in Arizona are starting to transition to a broadband platform and/or wireless services the
20 access subsidies supporting the universal service goal will vanish. The extremely low
21 retail rates must therefore increase when it can no longer be supported by the current
22 implicit subsidy source.

³ ALECA members have recognized this lack of sustainability. See whitepaper titled "The Case for Arizona Access Charge Reform," by the Arizona Local Exchange Carrier Association (ALECA), dated November 2, 2006.

1 Q. COULD YOU PLEASE SUMMARIZE YOUR RESPONSES TO ISSUES 1
2 THROUGH 12?

3 A. Yes. Below are brief summaries of my responses.

- 4 • **Issue 1 Response** - All Arizona local exchange companies who operate under the
5 jurisdiction of the Arizona Corporation Commission (specifically Qwest, Verizon,
6 all independent telephone companies regulated by the ACC, including the
7 ALECA members, and the CLECs) should have their access charges reformed.
8
- 9 • **Issue 2 Response** - The Commission should order all LECs to reduce their
10 intrastate switched access rates and structure to match their corresponding
11 interstate rates. This will also result in "capping" CLECs' intrastate rates so that
12 they cannot exceed the corresponding rates of the ILECs in whose service
13 territory they compete, because those caps exist on their interstate rates.
14
- 15 • **Issue 3 Response** -- AT&T recommends that the Commission require all
16 Incumbent local exchange carriers, no later than 60 days after the effective date of
17 necessary revisions to the AUSF rules approved in its order in this proceeding, to
18 reduce their intrastate switched access rates to the ILECs' interstate rate structures
19 and levels and, within 60 days of the date of this order, require all CLECs to
20 adjust their intrastate tariffs so that their access charges do not exceed those
21 assessed by the ILEC in whose territory they operate. Each ILEC should also be
22 directed to update and mirror its intrastate tariff anytime it changes its interstate
23 rates in the future and CLECs should file conforming changes to match those of
24 the ILEC with which they compete.
25
- 26 • **Issue 4 Response** - Individual companies should be allowed to adjust or respond
27 to business needs by entering into special business arrangements that reflect
28 changing market conditions. Because of the time it normally takes to arrive at a
29 regulatory solution (months or even years depending on the complexity of the
30 issues involved) companies may suffer undue economic harm if not allowed the
31 flexibility to derive business solutions in the form of mutual agreements.
32
- 33 • **Issue 5 Response** - The Commission should allow all carriers to recover access
34 revenue reductions by giving them flexibility to increase their retail rates for local
35 service, and in certain cases (i.e. when retail rate increase by an incumbent local
36 exchange carrier will not be sufficient for revenue neutral recovery), ILECs
37 should be eligible receive access replacement revenue from the Arizona universal
38 service fund.
39
- 40 • **Issue 6 Response** - The Commission should establish a benchmark mechanism
41 that allows carriers to recover part of their access reduction from increased retail
42 rates to end users up to the benchmark level, and, in certain cases, the balance if
43 any could be recovered by allowing incumbent LECs to draw support from an

1 Access Replacement Fund drawn from a modified AUSF. I will describe below a
2 reasonable approach to setting a benchmark level
3

- 4 • **Issue 7 Response** – To calculate the AUSF support provided to offset access rate
5 reductions, incumbent local exchange carriers would first calculate and verify the
6 amount of access revenue lost when *intrastate* access rates are reduced to their
7 corresponding *interstate* levels. Then, they would calculate the additional
8 revenue from authorized rate increases for retail local services, if rates were raised
9 up to the benchmark level. The difference would be the amount of access
10 replacement revenue to be made available from the AUSF. Any carrier may also
11 file to increase other rates to offset revenues lost as a result of intrastate access
12 rate decreases on a showing that such rate increases are revenue neutral to the
13 access rate decreases.
14
- 15 • **Issue 8 Response** – The current AUSF rules do not clearly authorize the use of
16 AUSF support to recover reductions in access revenues, nor are they designed to
17 fund support for that purpose. They should thus be revised to include at least the
18 following: (i) a provision that allows eligible carriers to draw from the fund to
19 recover lost switched access revenue, specifically describing how the amount to
20 be drawn would be calculated, and identifying the supporting documentation that
21 the eligible carrier must provide in order to qualify for a revenue replacement
22 support; (ii) provisions describing the contribution methodology, the sources of
23 contributions to the fund; (iii) a provision that provides carriers an option to
24 recover their contribution assessment rate through a surcharge; and (iv) a
25 provision that specifies eligibility criteria for carriers to draw access replacement
26 support from the fund. The Rules for the distribution of high-cost support would
27 not be affected.
28
- 29 • **Issue 9 Response** – CLECs do not need to draw access replacement revenue from
30 the AUSF; they should have the flexibility to increase local retail rates sufficiently
31 to recover any forgone access revenue as a result of the proposed access reform.
32 Only ILECs whose retail rates have been traditionally set as part of the legacy
33 subsidy system should be allowed to receive access replacement support from the
34 modified AUSF, after they had first looked to recover their own lost access
35 revenues through retail rate flexibility to a benchmark level adopted by the
36 Commission.
37
- 38 • **Issue 10 Response** – The proposed revisions to allow either the retail rate
39 flexibility or receipt of access replacement revenue from the AUSF should be
40 implemented such that carriers are neither net gainers nor losers of revenue as a
41 result of access reform. The result should be revenue neutral, and it should not
42 result in any change to the existing High Cost support. Rather, it would simply be
43 a separate source of support that serves a separate purpose.
44
- 45 • **Issue 11 Response** – Contributions to the AUSF, to satisfy the existing support
46 needs and the proposed access revenue replacement function here, should come

1 from *all* telecommunications providers, on an equitable, non-discriminatory and
2 competitively neutral basis. As a general matter, the contribution methodology
3 employed for the AUSF should mirror the approach currently implemented for the
4 federal USF, i.e. based upon a percentage of interstate/international retail (end
5 user) telecommunications revenues. At present, the intrastate counterpart of that
6 approach in Arizona will be for the AUSF contribution to be based upon a
7 percentage of the total Arizona's retail intrastate telecommunications revenues.
8

- 9 • **Issue 12 Response** - AT&T will file specific AUSF rules language with its reply
10 testimony after it has reviewed other parties' direct testimony on these issues.
11

12 **Q. HOW IS YOUR TESTIMONY ORGANIZED?**

13 **A. Section II** provides a brief background and history of switched access charges and
14 explains why the current switched access charges are no longer just and reasonable given
15 the dramatic changes to the telecommunications industry during the last decade. I show
16 that excessive switched access rates are creating competitive distortions that harm
17 competition, consumers, and Arizona's economy. In general, I will illustrate the
18 problems that arise when wireline IXC's are required to pay intrastate access charges their
19 competitors do not pay, and why this practice is so discriminatory and harmful to
20 consumers.

21 **Section III** answers the specific questions posed by the ALJ's procedural order. I begin
22 by demonstrating that the Commission should apply its reforms equally to all LECs,
23 rather than giving preferential treatment to some LECs (Issue 1). Next, I show that the
24 Commission should reduce all ILEC's intrastate access rates to match their corresponding
25 interstate rates, thereby giving Arizona consumers the benefits of reforms adopted at the
26 federal level and joining the many other states that have implemented interstate parity
27 (Issues 2 and 3). I will also explain that the Commission should simultaneously require
28 the CLECs to mirror the specific rates of the ILEC's with which they compete; again

1 following reforms adopted at the federal level and replicating the outcome that would be
2 expected in a competitive market. I will show how consumers will benefit from
3 reductions to the LECs' intrastate access rates. I will also discuss how interstate parity
4 will simplify billing, reduce carrier costs, reduce incentives for arbitrage, and discourage
5 or prevent illicit schemes some carriers have devised to take advantage of (or avoid) high
6 intrastate access rates. After that, I will demonstrate that carriers should be permitted to
7 contract for access rates that differ from tariffed rates, so that carriers can voluntarily
8 develop, negotiate, and enter into arrangements that provide even greater benefits to
9 consumers (Issue 4).

10 I then turn to issues related to the recovery of access revenue reductions and
11 AUSF support. I will begin that discussion by describing what revenue sources, if any,
12 should be made available to LECs to compensate for the reduction in access revenues that
13 will result from access rate reform (Issues 5 and 6). As I explain below, that recovery
14 should come from a combination of (i) flexibility to set retail rates for local service and,
15 (ii) for carriers that can demonstrate that they cannot recover their costs without
16 increasing rates above an affordability benchmark established by the Commission,
17 explicit support from the AUSF. I will then discuss the procedure for carriers to obtain
18 support from the AUSF "revenue neutral" recovery of access reductions and the method
19 for determining support amounts (Issue 7). Next, I will describe how the AUSF rules
20 should be revised to allow for this explicit support, the eligibility requirements for
21 carriers to obtain support, and the contribution methodology (Issues 8 through 12).

1 **II. BACKGROUND AND HISTORY OF SWITCHED ACCESS CHARGES.**

2
3 **A. LONG-DISTANCE CALLS AND SWITCHED ACCESS SERVICE.**

4
5 **Q. PLEASE EXPLAIN WHAT SWITCHED ACCESS CHARGES ARE.**

6 **A.** Switched access charges are the fees that a local exchange carrier assesses upon wireline
7 long distance providers when the LEC originates or terminates long distance calls made
8 or received by the LEC's local service subscribers. The LEC owns the "loop" that
9 connects those subscribers to the LEC's switch and the rest of the public switched
10 telephone network. For example, when a Qwest basic local service subscriber in Tucson
11 wants to use AT&T's long distance service to call a Citizens-Frontier basic local service
12 subscriber in Kingman, AT&T must (i) pay Qwest an *originating* switched access charge
13 for the carriage of the call from the subscriber's location to AT&T's network, and (ii) pay
14 Citizens-Frontier a *terminating* switched access charge for the delivery of the call from
15 AT&T's network to the called party in Kingman. If the same Qwest subscriber in Tucson
16 makes an AT&T intrastate long distance wireline call to another Qwest subscriber in
17 Prescott, AT&T must pay Qwest *both* originating and terminating intrastate access
18 charges.

19 **Q. WHAT FUNCTIONS DOES A LEC PERFORM WHEN IT PROVIDES**
20 **ORIGINATING SWITCHED ACCESS SERVICE?**

21
22 **A.** When a consumer places an interexchange call (either an intrastate or interstate call) from
23 a wireline phone, the call travels from the calling party's location over loop provided by
24 the LEC that serves that caller,⁴ to that LEC's local serving office (sometimes called an
25 "end office" or "central office"). There, the call is directed to the LEC's local switch,

⁴ Loop costs are considered "non traffic sensitive" because they do not vary if the customer uses the loop for only local calling, only long distance calling, or not at all. Nor do the costs vary if the customer uses the line for hours a day, or for mere minutes a day. Thus, as a matter of sound economic theory and following cost causation principle, it is more appropriate to recover these costs via fixed monthly charges assessed to the end user customer.

1 which electronically routes the call along a wired path known as a transport trunk to the
2 interexchange carrier's point of presence ("POP"). At that point, the LEC hands the call
3 off to the interexchange carrier and the originating access service ends.⁵ The origination
4 functionality is performed in the same manner, using the same equipment and facilities,
5 regardless of the identity of the interexchange carrier, regardless of the intercarrier
6 compensation regime that applies to the call, and regardless of the call's ultimate
7 destination (interstate or intrastate). I provide an illustration of originating access in the
8 diagram provided in response to the next question.

9 **Q. WHAT FUNCTIONS DOES THE LEC PERFORM WHEN IT PROVIDES**
10 **TERMINATING ACCESS SERVICE?**

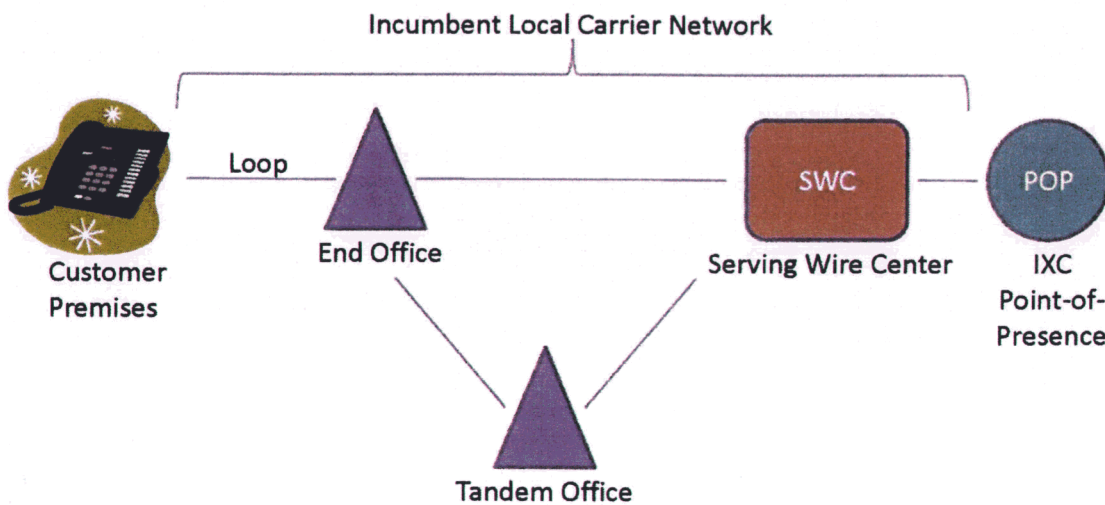
11
12 **A.** The process for completing or "terminating" a call to a wireline phone works the same
13 way as originating access, but in reverse. Picking up where I left off in the previous
14 illustration, after the IXC receives a call from the originating LEC, the IXC carries the
15 call on its own network to its switch nearest the called party's location. From there, the
16 IXC hands off the call to the LEC that serves the party on the receiving end of the call.
17 The terminating LEC performs the same functions as an originating local carrier, just in
18 reverse order: it uses its tandem switching (if necessary) and local transport facilities to
19 take the call from the IXC's switch to the local switch in the end office that serves the
20 called party, and that switch then routes the call over the terminating LEC's local loop to
21 the called party's telephone based upon the called number. As with call origination, call
22 termination is provided in materially the same manner, using the same equipment and
23 facilities, regardless of the identity of the IXC, regardless of the intercarrier compensation

⁵ Depending upon the transport arrangements the access purchaser has made with the other carrier (ILEC or CLEC), the call may first be routed from an end office to a LEC or CLEC intermediate "tandem" switch before being delivered to the purchaser's switch, sometimes termed its "Point of Presence" or "POP."

1 regime that applies to the call, and regardless of whether the call comes from an intrastate
2 or interstate location.

3 The diagram below illustrates originating and terminating access.⁶

Network Access Diagram



⁶ This diagram only shows the shared facilities option. The IXC can choose to interconnect directly at either the End Office or the Tandem via switched dedicated facilities; in either case, the function performed by the ILEC is the same.

1 **B. THE ILECS' CURRENT INTRASTATE SWITCHED ACCESS**
2 **RATES ARE INFLATED BY IMPLICIT SUBSIDIES.**

3
4 **Q. PLEASE PROVIDE A BRIEF OVERVIEW OF THE HISTORICAL**
5 **DEVELOPMENT OF THE ARIZONA LECS' INTRASTATE SWITCHED**
6 **ACCESS RATES.**

7
8 **A.** Historically, a single monopolist controlled both local and long distance phone service in
9 its assigned territory, and the applicable state commission regulated its prices. At that
10 time, Arizona and other states set prices for some services (such as long-distance toll
11 service, and local service for business customers) above cost, to subsidize below-cost
12 prices for other services (such as residential local service in high-cost areas).⁷ Consumers
13 had little choice but to pay those regulated prices if they wanted to make long-distance
14 calls.

15 With the breakup of the Bell System in 1984, local and long-distance service were
16 "split" and the system of interstate and intrastate switched access charges, assessed by
17 local carriers on long-distance IXCs, was established. IXCs carried (interLATA) long
18 distance calls between their long distance switching facilities and paid switched access
19 charges to the LECs to connect the call from the end-user locations to the IXC switches.
20 Continuing the old practice of using long-distance prices to subsidize local service,
21 switched access charges were set far in excess of the related switching and transport
22 costs, to generate a subsidy for the LECs to keep local exchange service rates below cost.
23 The IXCs then recovered their switched access expense through the retail prices they
24 assessed to their end-user long distance customers. Thus, for consumers, the implicit
25 subsidy in access charges was in many ways like a hidden surcharge buried in their long
26 distance rates.

⁷ Qwest also concludes that high access charges are subsidizing local retail rates. See Qwest Response to Staff Data Request STF 01-024(c).

1 Economists recognize that this system sacrificed economic efficiency in pursuit of
2 universal service, and that it could be sustained only as long as traditional wireline long
3 distance calls were consumers' only real option for long distance voice communications.
4 In that closed system, it was mechanically possible to overprice long distance in order to
5 under-price basic local phone service as a way to promote "universal service," because
6 consumers options for escaping the high prices for long-distance service were far more
7 limited and far less adequate substitutes (e.g., mail, telegraph, or no communications at
8 all).

9 **Q. IS IT STILL POSSIBLE IN TODAY'S MARKET TO COUNT ON OVER-**
10 **PRICED LONG-DISTANCE SERVICE IN ORDER TO SUBSIDIZE LOCAL**
11 **PHONE SERVICE?**

12
13 **A.** No. Such subsidies cannot be maintained in today's highly competitive and
14 technologically diverse telecommunications market, simply because it is no longer a
15 "closed" environment. New competitors, most of them substantially less regulated, have
16 deployed new technologies (some not even contemplated when the access charge regime
17 was established in 1984) to give consumers a broad range of options for long distance
18 communications. These competitors do not pay the excessive access charges to the same
19 extent that wireline long-distance carriers, like AT&T, must pay. Customers who want to
20 communicate over long distances can use wireless phones, Voice over Internet Protocol
21 ("VoIP"), electronic mail, instant messaging, Skype, or other alternatives in place of
22 wireline long-distance calling, and thus avoid paying high access charges.

23 **Q. DOESN'T THIS ADVANCE COMPETITION IN ARIZONA?**

24 **A.** No. High access charges put one group of competitors (wireline IXCs) at a huge, artificial
25 and unfair competitive disadvantage. AT&T and other wireline IXCs are being forced to

1 pay excessive access charges to subsidize the LECs' local service, while other
2 communications services do not have to bear the same burden. Efficient competition—
3 competition that maximizes consumer benefits--is advanced when consumers can pick
4 among competitors based on real economic differences like quality, customer service,
5 and real economic cost, not purely artificial differences.⁸ AT&T wants to compete for
6 Arizona long distance consumers, but if the Commission fails to remove the huge and
7 artificial cost disadvantage that AT&T must bear, then AT&T cannot offer consumers the
8 same competitive rates that it could offer if that unfair disadvantage were removed. The
9 Commission's policy should be to level the competitive playing field such that consumers
10 should decide the market's winners and losers.

11 **Q. HOW LARGE IS THE COMPETITIVE DISADVANTAGE THAT HIGH**
12 **INTRASTATE SWITCHED ACCESS CHARGES IMPOSE TODAY?**

13
14 **A.** As things now stand, intrastate access charges as high as 13 cents per minute, *for only*
15 *one end* of an in-state call, are being imposed almost exclusively on long distance
16 interexchange carriers such as AT&T. Meanwhile, new forms of communications which
17 be used in place of traditional long distance communications – internet service providers,
18 VoIP providers,⁹ text messaging providers,¹⁰ e-mail providers,¹¹ wireless carriers,¹² social

⁸ I would expect Qwest to agree, given the remarks of its CEO that “these charges greatly exceed their actual costs and vary greatly based upon unrelated factors, such as the type of call, the jurisdiction of the call, or the identity of the carrier. Such distinctions are neither practical nor rational in today’s communications industry.” See Remarks of Qwest Chairman and CEO Edward A. Mueller at the 120th annual National Association of Regulatory Utility Commissioners (NARUC) convention in New Orleans on Nov. 17, 2008.

⁹ VoIP providers include “interconnected” providers such as cable operators or Vonage, which offer services that can make calls to and receive calls from the public switched telephone network. See 47 C.F.R. § 9.3. Other providers such as Skype are generally “non-interconnected” and operate computer-to-computer; consumers perceive those calls as “free.”

¹⁰ Text messaging providers include wireless providers, and a range of other texting options.

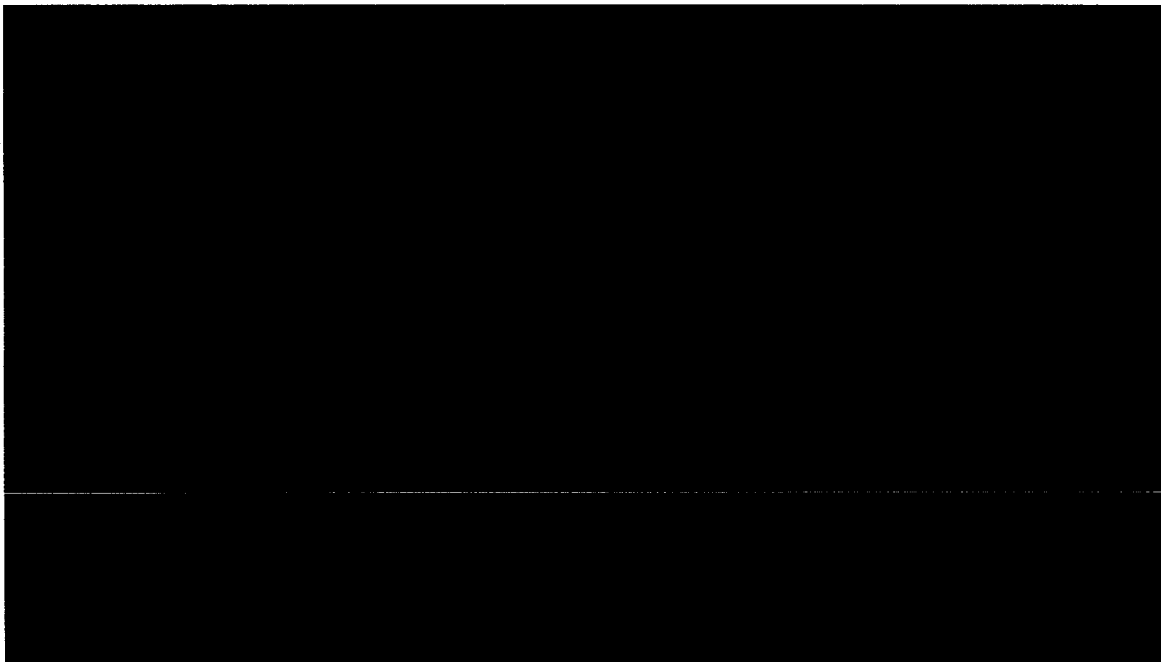
¹¹ E-mail providers include America On-Line (AOL), and Internet providers, as well as Yahoo, Hot Mail and a large number of other providers.

¹² Wireless carriers include Verizon Wireless, AT&T Mobility, Sprint/NexTel, T-Mobile, and others.

1 networking websites,¹³ – are generally able to complete their calls for as little as 7/100ths
2 of a cent per minute (\$0.0007), or in the case of e-mail traffic (or social networking
3 websites), essentially for free. The difference between access charges and the 7/100ths of
4 a cent wireless intraMTA call termination rate is *more than 18,000%*. No one can
5 seriously defend a regime where one type of carrier is charged so much more than
6 another for the same functionality. The following table illustrates these massive
7 disparities:

8 **Figure 1**

9 **BEGIN HIGHLY CONFIDENTIAL**



10
11 **END HIGHLY CONFIDENTIAL**

12
13
14 **Q. COULD YOU ILLUSTRATE THE DISPARITY BETWEEN ARIZONA**
15 **CARRIERS' INTRASTATE AND INTERSTATE ACCESS RATES?**
16

¹³ Social Networking sites include Facebook, Twitter, MySpace, LinkedIn, and others.

1 A. Yes, the disparity is demonstrated by the next chart:

3 **Figure 2**

4 **BEGIN HIGHLY CONFIDENTIAL**



5
6
7 **END HIGHLY CONFIDENTIAL**

8
9
10 As one can see from the chart, intrastate access rates can be as high as 4,000% more than
11 the corresponding interstate rate, even though from a LEC's perspective both intrastate
12 and interstate switched access services involve the same function and the LEC incurs the
13 same cost.

14
15 **Q. WHY IS THERE SUCH A DISPARITY BETWEEN INTRASTATE AND**
16 **INTERSTATE SWITCHED ACCESS RATES, WHEN THE UNDERLYING**
17 **FUNCTION IS THE SAME?**

18
19 **A.** The disparity is purely artificial, driven by legacy regulation. The FCC regulates
20 interstate switched access rates while state commissions have oversight authority on

1 intrastate switched access rates. Originally, the system of subsidies existed at the federal
2 level too, but over several years the FCC has implemented significant reforms to the
3 federal regime. These federal reforms have significantly reduced - although not
4 eliminated - the implicit subsidies that had been buried in interstate switched access rates.
5 As I show below, it is time (and in fact past time) for this Commission to adopt similar
6 reforms at the state level.

7
8 **Q. YOU POINTED OUT THAT INTRASTATE SWITCHED ACCESS CHARGES**
9 **INCLUDE A SUBSIDY THAT WAS INTENDED TO "HELP" CONSUMERS BY**
10 **REDUCING LOCAL EXCHANGE PRICES, BUT HAVE THESE SUBSIDIES**
11 **REALLY HARMED CONSUMERS?**

12
13 **A.** Unquestionably, yes. First, high access charges mean that consumers are paying more
14 than they should for intrastate long distance. While access rates vary across Arizona
15 LECs, such that some LECs charge rates that are lower than others, the effects are spread
16 across consumers throughout Arizona, not just those served by the LECs with the highest
17 access charges. By law, IXCs must maintain statewide averaged long distance rates, so
18 excessive LEC access charges drive up the price of all long-distance calls: they affect
19 calls from Tucson to Flagstaff just as much as they affect calls from Kingman to
20 Holbrook.¹⁴

21 A deeper problem is that the access subsidy distorts and overstates the true cost of
22 wireline long-distance service, and prevents IXCs from fully competing against other
23 communications services like wireless carriers and e-mail or social networking websites.
24 Likewise, implicit subsidies distort the true price of wireline local services, because local
25 carriers subsidize below-cost local rates through high access charges. Consumers are

¹⁴ Section 254(g) of the Act requires IXCs to geographically average their interstate toll rates and thereby spread high-cost access charges across all of their end users. As a practical matter, IXCs often do the same with intrastate toll rates to enable uniformity in billing. *See* 47 U.S.C. § 254(g).

1 best served when prices reflect underlying cost and all competitors can compete on a
2 level playing field.

3 As I discuss later, the high access rates has motivated some chat line operators
4 and other unsavory actors to game the systems and create traffic pumping schemes –
5 which ultimately harms all consumers.

6
7 **III. RESPONSES TO SPECIFIC ISSUES RAISED BY PROCEDURAL ORDER**

8
9 ***ISSUE 1: WHAT CARRIERS SHOULD BE COVERED BY ACCESS REFORM?***

10
11 **Q. WHAT CARRIERS SHOULD BE COVERED BY ACCESS REFORM?**

12
13 **A.** All Arizona local exchange companies who operate under the jurisdiction of the Arizona
14 Corporation Commission (specifically Qwest, Verizon, all independent telephone
15 companies regulated by the ACC, including the ALECA members, and the CLECs)
16 should have their access charges reformed in order to promote efficient competition in
17 the Arizona telecommunications industry, and keep Arizona ahead of the transition
18 toward efficient adoption of different types of innovative technologies, e.g. broadband.¹⁵
19 High access charges and implicit subsidies hurt consumers and competition no matter
20 which LEC collects them. The Commission has all of these LECs before it now. It
21 should address all LECs equally, now, rather than allowing some LECs to continue
22 collecting implicit subsidies and distorting the telecommunications market for all
23 consumers across the state.

¹⁵ Dr. Aron discusses in her testimony how continuing with the current implicit subsidy system can impede efficiency and discourage investment and innovation.

1 **Q. THE CLECS DID NOT HAVE HISTORICAL MONOPOLIES ON LOCAL**
2 **SERVICE. WHY SHOULD THEY HAVE THEIR ACCESS CHARGES**
3 **REDUCED ALONG WITH THE ILECS' CHARGES?**

4 **A.** For at least four reasons. First, and most importantly, while CLECs did not and do not
5 have market power in retail local service, they (and other LECs) do have market power in
6 the wholesale access market. If an AT&T end user calls a home or business served by a
7 CLEC, AT&T *must* deliver the call to that CLEC and pay that CLEC's terminating
8 access charge no matter how high that charge is. AT&T simply has no choice. It is not
9 permitted to block the call, nor can it deliver it to a different LEC and avoid the high
10 access expense. Moreover, AT&T cannot charge a higher long-distance price for that
11 call (or for calls to customers of that CLEC), to give the end user an incentive to avoid
12 calling that CLEC's customers. Instead, AT&T has to average its long-distance prices
13 for all customers in a geographic region.

14 The same is true for originating access: If an AT&T end user chooses a particular
15 CLEC for local service, AT&T has to accept that end user's long-distance calls and pay
16 that CLEC's originating access charges. AT&T cannot block calls, it cannot forbid its
17 end users to choose a particular CLEC for local service, and because of geographic
18 averaging requirements AT&T cannot charge higher rates to end users that use a
19 particular CLEC for local phone service. Under these circumstances, consumers receive
20 incorrect price signals and are unaware of the true cost of the service they receive, and
21 they select a CLEC without knowing that their decisions cause their long-distance carrier
22 to pay the CLEC's excessive access charges.

23 Second, implicit subsidies and inflated access charges are harmful no matter what
24 LEC assesses the charges and collects them. The harm comes because IXC's (and their

1 retail customers) *have to pay* those charges, without an opportunity to refuse doing
2 business with the CLEC, the way firms can in a competitive market.

3 Third, the access service that CLECs provide is identical, in all material respects,
4 to the access service that ILECs provide. CLECs should not receive preferential
5 treatment, and they should not receive higher payments than the ILECs for what is the
6 same function. Such an artificial advantage distorts competition for local service, on top
7 of the distortion that high access charges cause for long-distance communications. It
8 gives CLECs the opportunity to use their inflated access charges to undercut the local
9 exchange rates of the ILECs so that they can win over the end user, who does not know
10 (or care) that the CLEC is only offering a "good deal" on local service because its access
11 charges are extraordinarily high.

12 Fourth, the fact that CLECs did not have historical monopolies on retail local
13 service gives the Commission even *more* reason to reform CLEC access rates. As I
14 discussed earlier, traditionally, ILECs charged high switched access rates to subsidize
15 below-cost local service and thus promoted universal service in rural areas. This was the
16 basic *quid pro quo* of the monopoly era. But unlike ILECs, CLECs do not have an
17 obligation to provide service to any customer. CLECs pick and choose their retail
18 customers, and they do not have to provide below-cost service to anyone anywhere. So
19 there is no *quid pro quo*: handing a subsidy to a CLEC is just handing a subsidy to the
20 CLEC, with no benefits for universal service.

1 **ISSUE 2 – TO WHAT TARGET LEVEL SHOULD ACCESS RATES BE REDUCED?**

2
3 **Q. SHOULD INTRASTATE SWITCHED ACCESS RATES BE REDUCED?**

4 **A.** Yes. As I describe in more detail in part (A) below, a meaningful and immediate
5 reduction in intrastate switched access rates is necessary. The massive implicit subsidies
6 in the LECs' current access rates harm consumers by artificially driving up the retail
7 price of wireline long distance service, and by unfairly disadvantaging one set of long-
8 distance competitors (wireline IXC's), which prevents consumers from achieving the
9 benefits of full and fair competition. Moreover, continuing to give massive implicit
10 subsidies for the old circuit-switched network distorts LECs' incentives to invest in new
11 broadband facilities.

12 As I discuss in part (B) below, reducing the LECs' intrastate switched access rates
13 will benefit consumers by reducing long-distance prices and promoting full and fair
14 competition. I also show that reducing intrastate switched access rates will encourage
15 efficient broadband deployment in Arizona.

16 More fundamentally, the old idea of implicit subsidies simply cannot be sustained
17 in today's competitive market and as those subsidies erode, support for universal service
18 in Arizona will vanish.

19 **Q. WHAT TARGET LEVEL SHOULD THE COMMISSION USE IN REDUCING**
20 **INTRASTATE SWITCHED ACCESS RATES?**

21 **A.** The Commission should order all LECs to reduce their intrastate switched access rates
22 and structure to match their corresponding interstate rates.¹⁶ In addition to the benefits

¹⁶ Although my proposal for the CLECs discussed above is that their intrastate rates are capped at the levels of ILECs in whose territories the CLECs compete, this essentially will mean that the CLECs will also mirror their

1 that will flow from reducing intrastate switched access rates generally, this "parity"
2 approach will yield several other benefits. First, parity is straightforward and allows the
3 Commission to capitalize on reforms adopted at the federal level (just as many other
4 states have done) while still keeping access rates above the related costs. Second, parity
5 between interstate and intrastate rates follows logically from the fact that both intrastate
6 and interstate switched access service are materially the same functions and should be
7 charged at the same price. Third, eliminating the disparity between interstate and
8 intrastate rates will simplify billing and decrease the incentive that the present system
9 creates for harmful arbitrage and fraud. I will discuss these benefits in more detail, later
10 in part (C).

11 **A. THE COMMISSION SHOULD IMMEDIATELY REDUCE THE LECS'**
12 **INTRASTATE SWITCHED ACCESS RATES.**

13
14 **Q. IN GENERAL TERMS, PLEASE DESCRIBE THE RATE STRUCTURE OF THE**
15 **ILECS' INTRASTATE SWITCHED ACCESS CHARGES IN ARIZONA.**

16 A. As a general matter, each ILEC has traffic sensitive rates for the switching function and
17 any transport functions it provides to IXCs. In addition, each ILEC has something called
18 a "Carrier Common Line Charge" (CCLC), which is a per minute of use charge that is
19 not cost based, does not exist on the interstate rate regime, and is nothing more than a
20 subsidy rate element designed from the beginning to subsidize basic local telephone
21 service.¹⁷

interstate rates since pursuant to FCC rules their interstate rates have been capped at the competing ILEC's interstate rate levels since 2001.

¹⁷ Attached as OAO Exhibit B is a list of the ILECs' Carrier Common Line Charges as obtained from their tariffs.

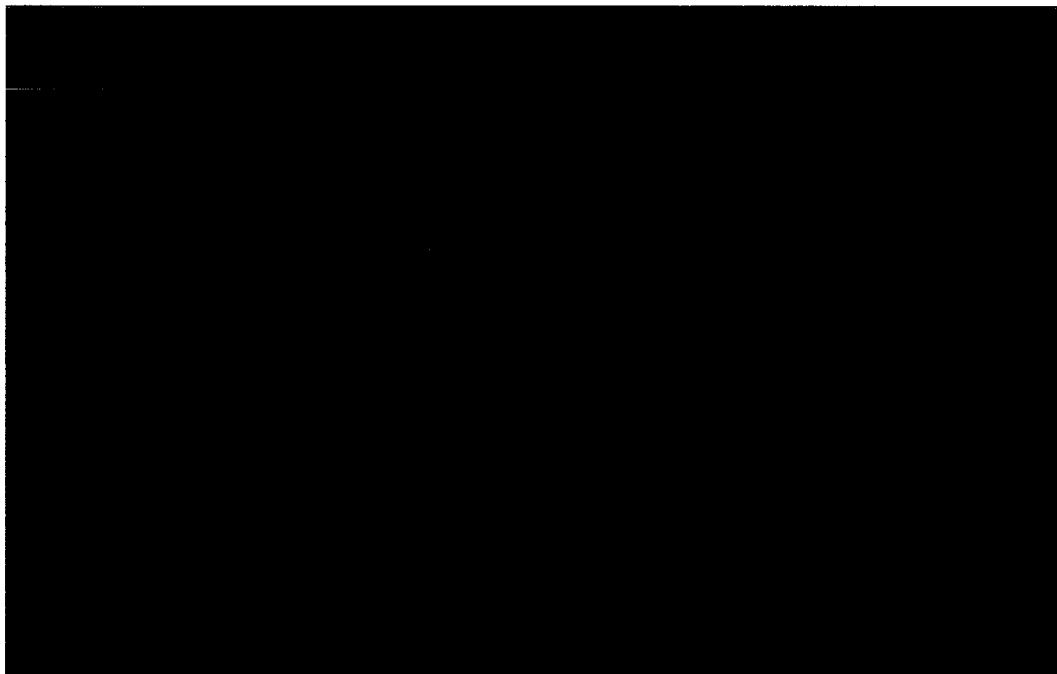
1 **Q. HOW MUCH DO THE ILECS CHARGE FOR INTRASTATE ORIGINATING**
2 **AND TERMINATING SWITCHED ACCESS IN ARIZONA?**

3
4 **A.** As shown in the tables below, the ILECs' intrastate switched access rates range anywhere
5 from about 2 cents per minute to as high as 13 cents per minute for either originating or
6 terminating access. So for an intrastate toll call that originates *and* terminates in Arizona,
7 AT&T must pay the applicable ILEC or ILECs as much as 4 to 26 cents per minute for
8 switched access.

9 **Q. DO SOME ILEC ACCESS CHARGES EXCEED AT&T'S AVERAGE RETAIL**
10 **LONG DISTANCE PRICE?**

11 **A.** Unfortunately, yes. As I show in the chart below, some ILECs assess AT&T per-minute
12 access charges in excess of the average price the competitive long distance market would
13 allow AT&T to collect from its retail consumers for every access minute. For those
14 particular ILECs, AT&T loses money on every minute of long distance calls originated
15 and terminated in those ILECs' service territories, even without taking AT&T's other
16 costs into account. These examples are illustrated below.

1 [BEGIN CONFIDENTIAL INFORMATION]



2

3 [END CONFIDENTIAL INFORMATION]¹⁸

¹⁸ In addition to comparing the long distance price with the average switched access rates among all ALECA members, AT&T has attached as OAO_Exhibit C charts comparing the switched access rates of Citizens-Frontier and Verizon.

1 **Q. HOW MUCH MORE ARE ARIZONA ILECS' INTRASTATE RATES HIGHER**
2 **THAN THEIR CORRESPONDING INTERSTATE RATES?**

3
4 A. As discussed and illustrated earlier, the Arizona ILECs' intrastate rates are as much as
5 4,000% higher than interstate.

6 **Q. IF ILECS USE THE SAME PROCESS AND FACILITIES FOR CALL**
7 **ORIGINATION AND TERMINATION AS YOU DISCUSS EARLIER, WHY ARE**
8 **THEIR INTRASTATE SWITCHED ACCESS RATES SO MUCH HIGHER**
9 **THAN THEIR INTERSTATE RATES?**

10
11 A. The ILECs' intrastate switched access rates were set during the time that access rates
12 were *intentionally allowed* to exceed their incremental costs by a substantial amount in
13 order to generate subsidies for local service rates. Although similar subsidies exist in
14 interstate charges, the FCC has implemented a series of reforms that reduced the level of
15 interstate subsidies. The Commission has yet to implement those reforms at the state
16 level, so there is currently a large gap between interstate and intrastate rates.

17 **Q. DO THE CLECS' CHARGE HIGHER INTRASTATE RATES THAN THE ILECS**
18 **IN WHOSE SERVICE TERRITORIES THEY OPERATE?**

19
20 A. Yes, the CLECs' rates are generally higher.

21 **Q. PLEASE EXPLAIN WHY THE CLECS' INTRASTATE RATES ARE SO MUCH**
22 **HIGHER THAN THE ILECS INTRASTATE RATES OR THE CLECS**
23 **INTERSTATE RATES?**

24
25 A. Originally, the market entry by CLECs was meant to create competition for local service,
26 and such competition was expected to infect switched access service and help constrain
27 access charges, but that has not happened after at least 13 years of CLEC presence in
28 telecommunications business. The reason is that the CLECs, like ILECs, have market
29 power over the facilities that connect their customer to the rest of the public switched
30 telephone network. The physical structure of the public switched telephone network
31 makes it impossible for more than one LEC to serve any single telephone line connecting

1 a customer's premises.¹⁹ So if an end user places a long-distance call to, or from, a
2 CLEC's line, the IXC *has to pay* the CLEC's access charge. It cannot ask some other
3 LEC to originate or terminate the call. And because of requirements in federal law that
4 IXCs charge averaged prices, the IXC cannot selectively increase its long-distance prices
5 on calls made to or from CLECs, in order to recover the access cost and send a signal to
6 the end user to choose lower-cost LECs.

7 The CLECs are taking advantage of all of these factors. They understand that if
8 the law precludes an IXC from selectively imposing higher toll rates on its customers
9 who take CLEC local exchange service, the CLEC has the opportunity to charge
10 excessive access rates. Those access rates will simply be averaged into the IXC's
11 statewide toll prices. In short, market forces cannot, and do not, discipline CLEC access
12 rates. The IXC cannot reasonably establish long distance prices that are specific to the
13 LEC that originates or terminates a call. Because by law IXC prices are averaged on a
14 statewide basis, the CLEC's end-user customer is insulated from knowing that his or her
15 long distance calling is imposing disproportionately high costs on the IXC. If left on
16 their own, the CLECs have an incentive to increase access rates as much as they can. In
17 this environment, the Commission needs to establish an appropriate cap on CLEC access
18 rates as the FCC has done since 2001.²⁰

¹⁹ As discussed earlier, other reasons include: 1) difficulty to geographically deaverage toll prices makes it impractical for IXCs to pass higher access costs directly to the end user that selects a LEC with high access rates — they are simply spread and essentially paid for by all consumers in the state, including those that select the more efficient low access LECs; 2) due to federal prohibition against call blocking IXCs cannot reject calls from or to a LEC that charges high access rate.

²⁰ See *In the Matter of Access Charge Reform, Reform of Access Charges Imposed by Competitive Local Exchange Carriers*, CC Docket No. 96-262, Seventh Report and Order and Further Notice of Proposed Rulemaking, 16 FCC Red 9923 (2001) ("*CLEC Access Reform Order*").

1 **Q. HOW DOES THE GROWTH OF COMPETITION AFFECT THE CURRENT**
2 **ACCESS CHARGE SYSTEM?**
3

4 A. With the growth in competition that I described earlier, the current system becomes
5 unsustainable. Implicit subsidies are incompatible with a competitive market, because
6 consumers will choose alternatives that allow them to avoid the subsidies and because the
7 competitors that have to bear the subsidy burden (in this case, IXC's) cannot fully
8 compete. Since competition is now widespread and is intensifying in segments of the
9 communications marketplace, providers should be recovering the costs of their retail
10 services from their own retail customers, rather than relying on subsidy payments from
11 other carriers. The Commission now has a great opportunity to modify its policy to
12 promote effective competitive outcomes that would benefit all Arizonans.

13 Competition has grown not only in the long distance market, but also in the
14 market for local retail service, and the ILECs themselves have recognized that fact.²¹
15 With competition this evident, the original purpose for which the implicit subsidies were
16 established has diminished, if not disappeared. Universal service does not need the same
17 subsidies, because consumers already have so many alternative options for their local
18 retail service.²²

²¹ See the following: i) Qwest 2008 annual 10K report, pp. 9, 12, 31:

https://materials.proxyvote.com/Approved/749121/20090316/AR_36466/HTML2/default.htm;

ii) Qwest July 30, 2009 10Q report, p.46: <http://phx.corporate-ir.net/phoenix.zhtml?c=119535&p=irol-SECText&TEXT=aHR0cDovL2NjYm4uMTBrd2l6YXJkLmNvbS94bWwvZmlsaW5nLnhtbD9yZXBvPXRlbmsmaXBhZ2U9NjQzODAwMiZhdHRhY2g9T04mc1hCUkw9MQ%3d%3d>

iii) Frontier 2008 annual 10K report, pp. 5, 7, 10: <http://phx.corporate-ir.net/External.File?item=UGFyZW50SUQ9MzMyMzg0fENoaWxkSUQ9MzE0Njk2fFR5cGU9MQ==&t=1>

²² If, however, the Commission believes subsidies would be appropriate in some areas or for a limited class of consumers, those subsidies should be explicit, and they should be drawn from a broad universal service fund to which all providers contribute in a competitively neutral manner. In a market where AT&T and other long distance companies must compete against a host of new technologies and new entrants that do not incur access charges in the same way, there is simply no reason to maintain intrastate access rates higher than interstate rates for the same functions.

1 **Q. PLEASE EXPLAIN FURTHER HOW COMPETITION IS NOW WIDESPREAD**
2 **IN ALL SEGMENTS OF THE COMMUNICATIONS MARKET.**

3 A. The manner in which consumers communicate has completely changed. Never before
4 have consumers enjoyed so many communications choices. They can order goods and
5 services over the Internet. They can network with their friends and colleagues through
6 Facebook, Twitter, MySpace, Linked In and a host of other social networking websites.
7 They can send a friend a text message on their mobile phone. They can obtain
8 government information and forms with a mouse click. They can obtain voice services
9 from a local telephone company, a long distance company, a wireless carrier, a cable
10 operator, or from a VoIP provider such as Vonage or Skype that allows them to utilize
11 their broadband computer connection for voice calls.

12 **Q. PLEASE EXPLAIN THE DIFFERENT TYPES OF COMPETITION THAT HAVE**
13 **GROWN IN RECENT YEARS.**

14
15 A. Let's begin with wireless service: as of June 2008, Arizona had almost 5 million wireless
16 subscribers, which means that at the end of 2008 some 76% of Arizona residents – that is
17 *residents*, not households – had a wireless phone,²³ And after excluding children younger
18 than 15 years of age, Dr. Aron has shown in her testimony that 97% of the state's
19 resident's have a wireless phone. In June 2003, there were 2.6 million wireless
20 subscribers, which mean that the number of wireless customers has increased in Arizona
21 by 87% in six years alone.

²³ In the Matter of Implementation of Section 6002(b) of the Omnibus Budget Reconciliation Act of 1993; Annual Report and Analysis of Competitive Market Conditions With Respect to Commercial Mobile Services; WT Docket No. 08-27, Thirteenth Report, Released January 16, 2009 ("FCC Thirteenth Competition Report"). This Report can be found at http://hraunfoss.fcc.gov/edocs_public/attachmatch/DA-09-54A1.pdf. The population of Arizona at year end 2008 was 6,500,180, so 76% of Arizonans had a wireless phone. See http://factfinder.census.gov/servlet/SAFFPopulation?_event=Search&geo_id=01000US&geoContext=01000US%7C04000US42&street=&county=&cityTown=&state=04000US04&zip=&lang=en&sse=on&ActiveGeoDiv=geoSelect&useEV=&pctxt=fph&pgsl=010&submenuld=population_0&ds_name=null&ci_nbr=null&qtr_name=null®=null%3Anull&keyword=&industry=++

1 Wireless carriers serve consumers across all of Arizona, including the ALECA
2 territories. That is consistent with the FCC's findings that, nationally, approximately
3 98.5% of the U.S. population living in rural counties has at least one or more carriers
4 offering mobile telephone service.²⁴ Other national reports reveal similar observations; a
5 growing number of consumers are now deciding to rely *exclusively* on wireless services.
6 A recent May 6, 2009, study from the Center for Disease Control observed that "one of
7 every five American homes (20.2%) had only wireless telephones during the second half
8 of 2008," and that the trend is accelerating.²⁵

9 Likewise, text messaging has literally exploded since the Commission last looked
10 at LEC access rates. The FCC reports that as of December 2007, customers sent 48.1
11 billion text messages a month compared to only 2.8 billion in December 2003.²⁶

12 Technologies such as DSL, broadband cable and VoIP have also become more
13 popular and those providers are challenging interexchange carriers in the marketplace.
14 The FCC reports that as of June 2008, there were 2,860,516 high speed lines in service in
15 Arizona, a number that has likely grown in the nearly eighteen months since the FCC
16 gathered that data.²⁷ The same report shows that every zip code in Arizona has at least
17 three high speed providers, and about 57% of those zip codes have at least ten high speed
18 providers. Any customer with a high speed connection can use that connection for
19 Internet access, e-mail, and social networking, as well as for free computer-to-computer
20 service such as Skype, or a computer to PSTN, to make voice calls and avoid traditional

²⁴ FCC Thirteenth Competition Report at ¶104. Paragraph 102 of the Report defines a "rural area" as a county with a population density of 100 persons or fewer per square mile.

²⁵ Blumberg and Luke, *Wireless Substitution, Early Release Estimates from the Nation Health Interview Survey, July -December, 2008*, <http://www.cdc.gov/nchs/data/nhis/earlyrelease/wireless200905.htm>.

²⁶ FCC Thirteenth Competition Report at p. 7.

²⁷ http://hraunfoss.fcc.gov/edocs_public/attachmatch/DOC-292191A1.pdf

1 subsidy-laden long distance prices. As of the end of 1st Quarter 2009, Skype reported
2 over 443 million users worldwide; adding 37.9 million new users in the 1st Quarter 2009
3 alone.²⁸

4 **Q. HOW DO THESE CHANGES SUPPORT AN IMMEDIATE REDUCTION IN**
5 **INTRASTATE SWITCHED ACCESS RATES?**

6 A. Suffice it to say, *none* of the alternatives to wireline long distance service is saddled with
7 access charges or subsidies in the same way as traditional wireline long distance. Not
8 only is it inequitable to impose a disproportionate subsidy burden on one industry
9 segment – IXC’s – but, as importantly, because the competitive alternatives I have
10 described are eroding wireline long distance traffic and thus the implicit subsidies in
11 access charges, the LECs cannot continue to rely on access subsidies going forward.
12 The Commission can now conclude that there is no reasonable argument for requiring
13 IXC’s to continue paying high anti-competitive access charges that their competitors do
14 not pay.

15 **Q. YOU POINTED OUT THAT OTHER SERVICE PROVIDERS DO NOT INCUR**
16 **ACCESS CHARGES IN THE SAME WAY AS IXCS. HOW ARE OTHER**
17 **PROVIDERS CHARGED DIFFERENTLY?**

18 A. Only wireline IXC’s incur intrastate switched access charges on virtually all of their
19 intrastate long distance calls. By contrast, other carriers incur access charges only on a
20 small portion or none of their traffic. It is beyond debate that the lion’s share of the
21 access charge burden falls squarely on the IXC’s.

22 Wireless carriers, for example, pay access charges only on long distance calls that
23 are routed outside the “Major Trading Area” (“MTA”) where the call originated. All
24 wireless calls *within* a MTA are treated as “local.” As a practical matter, that means most

²⁸ <http://ebayinkblog.com/2009/04/22/newsroom-april-2009/>

1 intrastate wireless calls are not subject to intrastate access charges because MTAs are
2 very large – in fact in Arizona a single MTA covers the majority of the state. The
3 Phoenix MTA (#27) covers most of Arizona, and spans from the southern to northern
4 border of the state, with only small parts of the state on the upper western and eastern
5 sides covered by the Los Angeles-San Diego MTA (#2) and El Paso-Albuquerque MTA
6 (#39) respectively.²⁹ All calls within MTA #27 are intraMTA calls, and are treated as
7 local calls subject only to FCC-established reciprocal compensation termination charges.
8 For carriers such as Qwest in Arizona that have opted into the FCC's ISP Remand
9 Decision that reciprocal compensation rate is \$0.0007 per minute, while other carriers
10 assess their Commission-approved local call termination charge for intraMTA wireless
11 call termination.³⁰

12 Similarly, VoIP-originated calls are not subject to originating access charges and,
13 in some instances, are terminated at reciprocal compensation rates instead of the much
14 higher switched access rate.³¹ Text messaging, instant messaging and email providers *pay*
15 *no terminating charges at all* – not even the much lower rates that wireless and VoIP
16 providers pay.

²⁹ <http://wireless.fcc.gov/auctions/data/maps/mta.pdf>.

³⁰ Qwest reports that, pursuant to interconnection agreements, it charges for intraMTA traffic reciprocal compensation rates in the range of bill and keep (i.e. \$0) to \$0.0009 per minute. See Qwest Supplemental Response to AT&T Data Request 03-009S1.

³¹ There have been disputes about the appropriate treatment of VOIP traffic caused by the arbitrage opportunities that some VOIP providers want to seize, and they contend that the FCC's "ESP exemption" excuses them from paying access charges for interconnection with PSTN. See AT&T's July 17, 2008 Ex-parte filing in "Re Developing a Unified Inter-carrier Compensation Regime, CC Docket No. 01-92; High Cost Universal Service Support, WC Docket No. 05-337; Federal-State Joint Board on Universal Service; CC Docket No. 96-45; Inter-carrier Compensation for ISP-Bound Traffic, WC Docket No. 99-68; Establishing Just and Reasonable Rates for Local Exchange Carriers. WC Docket No. 07-135. Some ILECs have opposed the VOIP provider's position, thus leading one to conclude that the issue of VOIP compensation remains ambiguous and unresolved and pragmatically VOIP calls are not consistently assessed the high access charges that are imposed on 100% of wireline IXC traffic. See also Petition of Feature Group IP for Forbearance from Section 251(g) of the Communications Act and Sections 51.701(b)(1) and 69.5(b) of the Commission's Rules, WC Docket No. 07-256 (filed October 23, 2007); Petition of Embarq Local Operating Companies for Forbearance from Enforcement of Section 251(b) of the Communications Act and Commission Orders on ESP Exemption, WC Docket No. 08-8 (filed January 11, 2008).

1 In short, this patchwork of rates for the same call completion functionality is anti-
2 competitive and unsustainable. AT&T and other wireline long distance carriers cannot
3 be expected to compete effectively if they must pay high intrastate access charges while
4 their competitors can complete calls for a fraction of a penny or for nothing at all.

5 **Q. DO LECs USE THE SAME FACILITIES TO TERMINATE WIRELINE,**
6 **WIRELESS AND VOIP CALLS?**

7
8 A. Yes. Once the call has reached the LEC's network and is handed off to the LEC either at
9 the end office switch or tandem switch, the process for terminating the call is materially
10 the same whether it is a wireline, wireless or VoIP call.³² This is another reason it is no
11 longer acceptable to require wireline IXCs to pay high switched access charges, when
12 competitors using different technologies pay much less or nothing for call origination and
13 termination.

14 **Q. ARE ASYMMETRIC RATES FOR TERMINATION HARMFUL TO**
15 **COMPETITION, CONSUMER WELFARE, AND ECONOMIC GROWTH IN**
16 **ARIZONA?**

17
18 A. Yes, the asymmetry is harmful to all three. As Dr. Aron already explains in her
19 testimony, the best (i.e. most valued) use of the society's scarce resources is when they
20 are committed to uses that "respond to consumer's tastes and preferences."³³ There is
21 evidence that consumers are beginning to change their preferences in favor of broadband
22 and other technologies, thereby slowly abandoning the presently subsidized PSTN circuit
23 network. For example, the trend across the country and in Arizona is that
24 communications services are increasingly being provided on the broadband platform, or
25 other technologies, and consumers are getting all of their communication needs bundled

³² Wireless and VoIP calls originate on different networks and therefore undergo protocol conversion where they are translated to the LECs' network protocol. This is transparent to the LEC.

³³ See Dr. Aron's Direct Testimony at Section VI (E).

1 from one source.³⁴ Therefore, it is wasteful for society (i.e. for Arizonans) to continue
2 allowing the current implicit subsidy system to continue to distort and "inhibit
3 competitors' ability" to operate on merit. With declining intrastate toll usage, subsidy
4 sources will evaporate and consumers who are heavily reliant on extraordinarily low
5 priced services will no longer have access to that support. It is too early to discern what
6 blend of pricing structures (e.g. either the newer bundled pricing for broadband and
7 wireless services or a different variety) would prevail, but it is not likely to be the current
8 implicit subsidy system. The Commission should act now to encourage an efficient
9 transition, and at the same time cushion consumers from a price shock, by gradually
10 transitioning the subsidy laden system towards more realistic prices. Moreover, because
11 broadband services have never had implicit subsidy sources like access charges, they
12 have been priced higher than local phone service rates which have reflected such implicit
13 subsidies. Gradually adjusting end user local phone services charges to eliminate
14 implicit subsidies will therefore better prepare consumers for the transition to (higher)
15 broadband service charges, and therefore may better encourage broadband service
16 adoption, a national goal.

³⁴ ILECs have realized this trend and are already taken steps to deploy broadband capability in their network, including by the ALECA members in rural Arizona. For example, TDS states, in its 2008 annual report, that it "continues to add broadband customers and increase data revenues through its ILEC operations, and the company is attracting commercial customers with high-speed broadband and voice solutions through its competitive local exchange carrier (CLEC) business. TDS Telecom's strategy of bundling broadband, voice, and video services is helping the company offset the revenue loss from a decline in voice service physical access lines." and "...at the end of 2008, approximately 90 percent of TDS Telecom's ILEC lines had access to DSL capability, and 85 percent of its ILEC DSL customers received 1.5 Mbps or faster service, with 52 percent having 3 Mbps or faster service. The company offers its commercial customers in certain markets speeds of up to 1G." See http://media.corporate-ir.net/media_files/IROL/67/67422/2008AR/html/letter.html.

This type of effort should be encouraged, not hampered or stalled by continuing the existing antiquated pricing system.

1 However, continuing to implicitly subsidize the legacy network when consumer
2 preferences are migrating to broadband services or other technologies provides the wrong
3 incentives for companies and distorts investment decisions as I mention above.

4
5 **Q. IN LIGHT OF THESE CHANGES IN THE TELECOMMUNICATIONS**
6 **INDUSTRY, CAN THE ARIZONA ILECS' EXISTING HIGH INTRASTATE**
7 **ACCESS CHARGES STILL BE CONSIDERED JUST AND REASONABLE?**
8

9 A. No. The emergence of these competitive alternatives means that even if the ILECs access
10 charges were once thought to be just and reasonable, they can no longer be considered
11 "just" or "reasonable" as competition from multiple sources and multiple technologies
12 has exploded. Rather, excessive access charges must be viewed for what they are – an
13 impediment to competition and a harm to Arizona consumers. No system can be
14 considered "just and reasonable" if it arbitrarily handicaps some competitors and favors
15 others.

16 Time is of the essence in correcting this problem. In 2008, IXC's (or, more
17 specifically, the IXC's' customers) paid the Arizona LECs approximately \$56 Million,
18 more than if intrastate switched access rates had been reduced to parity with interstate
19 rates.³⁵ *Every day* IXC's (or, to be more precise, IXC's' customers) are paying the Arizona
20 LECs \$155,000 more than if intrastate switched access rates were set at interstate
21 levels.³⁶ That is a huge competitive disparity that demonstrates the current intrastate
22 access rates are unjust and unreasonable. The Commission should eliminate that
23 disparity.

³⁵ These numbers are based on third party Highly Confidential data submitted by LECs in response to data request. The vintage varies ALECA submitted 2007 while others are based on 2008 data. Also the ALECA data are aggregated and are not provided on a carrier by carrier basis. AT&T may adjust its analysis once more updated data are received.

³⁶ *Id.* See OAO_Exhibit D.

1 **Q. DOES THE GROWTH OF ROBUST COMPETITION AFFECT ONLY IXCS?**

2 A. No. As I have noted, the dramatic changes to the competitive market put the ILECs at
3 risk if intrastate access rates remain at such high levels. The characteristics of today's
4 communications marketplace are such that consumers are showing preference for getting
5 all of their communications needs from only one source, including local service.
6 Therefore, to the extent high long distance rates are a contributing factor in consumers'
7 decisions to move to different technologies, it is also going to be a factor in consumers'
8 decisions to discontinue ILECs' wireline local service altogether and to seek bundled
9 packages from alternative technologies. As that is occurring, ILECs are being forced to
10 recover their costs from a continually shrinking customer base. Ironically, then, high
11 access charges are drying up the stream of subsidies they were supposed to provide, and
12 the ILECs have expressed concerns as noted earlier.³⁷

13 The ILECs' concerns are not merely theoretical. In Arizona, they have lost 30%
14 of their access lines since 2003, and in the last two years alone, the line loss has averaged
15 8% per year.³⁸ Undoubtedly, because the implicit subsidies embedded in wireline long
16 distance rates adversely affect consumer perceptions of value, an ever-increasing number
17 of consumers are deciding to forego wireline service altogether. I previously noted the
18 May 6, 2009, report from the Center for Disease Control that "more than one of every
19 five American homes (20.2%) had only wireless telephones during the second half of

³⁷ The ILECs themselves have recognized that subsidies exist in access charges and have acknowledged the trend across the country where there are continued push to have the subsidies removed. They are also aware that facilities-based local competitors and other non-traditional providers have targeted their customers, and they are bracing for continued revenue losses from access services as they continue to lose those customers. See e.g. Frontier 2008 Annual 10K Report; and Qwest Response to Staff Data Request STF 01-024.

³⁸ Based on AT&T analysis of ILEC's data submitted to NECA. Source: NECA USF Data Submission for 2002 to 2007, Universal Service Fund Data, NECA Study Results, DL070_CAT_13_LOOPS (Released September 2008); <http://www.fcc.gov/wcb/iatd/neca.html>.

1 2008,” and that the trend is accelerating.³⁹ At least in part, consumers are deciding to
2 forego wireline service in favor of other technologies (e.g. wireless, VOIP, text
3 messaging, social networking, etc.) because they perceive traditional wireline long
4 distance calls to be expensive, relative to these alternative forms of communication that
5 are sometimes available at no charge.

6
7 **B. ARIZONA CONSUMERS AND LECS WILL BENEFIT FROM**
8 **REDUCING INTRASTATE SWITCHED ACCESS RATES.**

9 **Q. WILL MEANINGFUL REDUCTIONS IN LECS’ SWITCHED ACCESS RATES**
10 **BENEFIT ARIZONA CONSUMERS?**

11 **A.** Yes. First, intrastate switched access charges are a principal component of the wholesale
12 cost that IXC’s incur when they provide retail long-distance service. In fact, as I
13 described earlier, today in certain instances AT&T must today pay per-minute intrastate
14 access charges that are *higher* than its per-minute retail prices for long-distance service.
15 Obviously, high wholesale costs drive up retail prices; conversely, decreases in the
16 wholesale cost of providing a service lead to a decrease in retail prices for that service. It
17 is a basic economics principle that all firms will maximize profit by reducing price when
18 their variable input costs are reduced. Thus, it is not surprising that economic research
19 confirms that wholesale cost reductions do result in lower retail prices.

20 **Q. PLEASE EXPLAIN HOW ACCESS REDUCTIONS HAVE RESULTED IN**
21 **LOWER RETAIL LONG DISTANCE RATES. WOULD THAT TREND**
22 **CONTINUE?**

23
24 **A.** Historical trends have shown that consumers’ toll prices have consistently declined
25 following decreases in switched access rates. Dr. Aron presents a trend chart in her

³⁹Blumberg and Luke, *Wireless Substitution, Early Release Estimates from the Nation Health Interview Survey, July – December, 2008*, <http://www.cdc.gov/nchs/data/nhis/earlyrelease/wireless200905.htm>.

1 testimony that represents that the series of FCC's actions that reduced access charges
2 over many years have resulted in lower interstate long distance prices for consumers.⁴⁰
3 Since competition for long distance service is even more robust now than in the past, any
4 decrease in intrastate access charges ordered in this proceeding will definitely benefit
5 Arizona consumers.⁴¹

6 The events of recent years are also instructive and lend more support to the
7 conclusion that reductions in access charges would be followed by decreases in long
8 distance prices. Recently, reductions in long distance prices have not only taken place
9 through tariff changes for a la carte service. Carriers in Arizona and other parts of the
10 country have introduced different lower priced calling plans in the form of bundled
11 packages. Each time a consumer selects a lower priced bundled package, that consumer
12 receives an effective price reduction and therefore real benefits. AT&T expects this trend
13 will continue because as access charges decline IXC's are even better positioned to reduce
14 end user toll prices.

15 Indeed, this wholly unremarkable proposition – that industry-wide cost reductions
16 will result in lower prices – has been proven time and again, in research including in the
17 independent study Dr. Aron presents showing that lower intrastate access charges –
18 which form a major portion of the cost of retail long distance services - are in fact
19 materially associated with lower AT&T's intrastate toll prices.

⁴⁰ Intrastate and interstate access are similar in all material respect, and they involve the same companies who lowered interstate prices (as expected by economics) when they experienced reduction in their interstate access expenses. Therefore one would expect the same economic incentive would prevail if intrastate access charges were reduced.

⁴¹ The interexchange market is highly competitive and that competition has reinforced price reduction as predict by economics. The IXC's reduce their toll rates to 1) compete against competitors lowering rates in response to industry-wide cost reductions, and 2) compete against competitors using technologies that do not incur access expenses, at least not in the same manner as IXC's.

1 **Q. IN WHAT OTHER WAYS WILL CONSUMERS BENEFIT FROM ACCESS**
2 **REDUCTIONS?**

3
4 A. While it would be premature for AT&T to predict in advance all the different ways its
5 long distance prices will change when access rates are reduced – in competitive markets,
6 firms are generally unable to predict what form price competition will take - I can affirm
7 here that there are two prices AT&T will reduce if intrastate access reductions are
8 implemented as AT&T propose here. First, AT&T will reduce its \$1.49 per line in-State
9 Connection Fee (“ISCF”) applicable to its stand-alone long distance customers. The fee
10 will be eliminated entirely when all Arizona LECs’ intrastate access charges are at parity
11 with their interstate access rates. Second, as it has done in other states when access
12 charges have been reduced, AT&T will reduce in-state rates for its prepaid calling cards.
13 That is a potentially important consumer benefit, because many low income consumers
14 use prepaid cards in lieu of traditional subscription wireline long distance.

15
16 **C. THE COMMISSION SHOULD USE INTERSTATE “PARITY” AS THE**
17 **TARGET FOR REDUCING INTRASTATE SWITCHED ACCESS RATES.**

18
19 **1. INTERSTATE “PARITY” IS A STRAIGHTFORWARD**
20 **APPROACH THAT WILL REDUCE ACCESS RATES BUT**
21 **KEEP THOSE RATES ABOVE COST.**

22
23 **Q. WHAT APPROACH SHOULD THE COMMISSION TAKE TO REDUCE**
24 **INTRASTATE ACCESS RATES?**

25
26 A. As many other states have already done, the Commission should require all local
27 exchange carriers to reduce their intrastate switched access rates to mirror their own
28 interstate rate structures and levels.⁴² Thereafter, each ILEC should be directed to update
29 its intrastate tariff at the very same time it changes its interstate rates, so that its intrastate

⁴² In this regard, if implemented in the revenue neutral manner proposed by AT&T there is no need for this proceeding to undertake cost review.

1 rates continue to mirror its interstate access rates. The CLECs should also be required to
2 adjust their intrastate tariffs within 60 days of the date of the order here such that their
3 access charges do not exceed those assessed by the ILEC with whom they compete. For
4 ILECs, these changes should take effect after the Commission has restructured the AUSF
5 to ensure that ILECs could rebalance part of the access reduction with access replacement
6 funding when retail rate flexibility is not sufficient.

7 **Q. WHAT ARE THE BENEFITS OF USING "PARITY" WITH INTERSTATE**
8 **RATES AS THE TARGET FOR ACCESS REFORM?**

9
10 **A.** The first benefit is that "parity" is a straightforward approach. As I described earlier, the
11 FCC has already implemented significant reforms to interstate switched access rates. The
12 Commission can take advantage of those reforms without having to reinvent the wheel,
13 simply by requiring the LECs to reduce their intrastate switched access rates to match the
14 corresponding rate structure and rate levels.

15 Further, because interstate access rates are still above cost, and because intrastate
16 access involves the same functions and the same cost, the Commission can be
17 comfortable that interstate rates will still be sufficient to cover intrastate access costs,
18 without having to analyze complex and highly contentious cost studies. Thus, many
19 other states have already taken the same "parity" approach that AT&T proposes here, as
20 detailed in Dr. Aron's testimony and in OAO_Exhibit F attached to my testimony.

21 **Q. HAVE ANY OF THE LECs CLAIMED THAT THEIR INTERSTATE ACCESS**
22 **RATES ARE BELOW INCREMENTAL COST?**

23
24 **A.** To the best of my knowledge, none of the LECs have *successfully demonstrated* in any
25 state or in the federal arena that their interstate switched access rates are below relevant

1 incremental costs or any other reasonable measure of cost.⁴³ I am not aware of a single
2 instance in which the FCC or any court has ever found any Arizona LEC's interstate
3 switched access rates to be below relevant cost.

4 **Q. THE FCC HAS ESTABLISHED COST BASED RATES THAT APPLY WHEN**
5 **CARRIERS DELIVER LOCAL CALLS TO ONE ANOTHER. DO THE FCC**
6 **FINDINGS REGARDING LOCAL CALL TERMINATION RATES SERVE TO**
7 **CONFIRM THAT LEC INTERSTATE ACCESS RATES ARE ABOVE**
8 **INCREMENTAL COST?**

9
10 **A.** Yes. Initially the FCC set local call termination rates at \$0.0015, but then decreased them
11 to \$0.0007⁴⁴, specifically finding that:

12 These rates reflect the downward trend in intercarrier compensation rates
13 contained in recently negotiated interconnection agreements, suggesting that they
14 are sufficient to provide a reasonable transition from dependence on intercarrier
15 payments *while ensuring cost recovery*.⁴⁵
16

17 The FCC's cost based rate is well below the LECs' interstate switched access rates
18 which, as illustrated in Figure 1, can be as low as 0.07 cents. Long distance calls
19 terminate in the same manner as local calls (using either end office or tandem office
20 facilities) and the routing involved in termination of all types of calls is identical, so the
21 cost of terminating a local call is the same in all material respects as the cost of

⁴³ AT&T has asked the LECs in this proceeding to identify any instances where they have claimed their interstate rates are below incremental cost, and the LECs did not provide any response that indicates this assertion is untrue. Also, given that most of the LECs' access volumes are likely to be interstate minutes, then it stands to reason that if the LECs' interstate switched access rates were set below cost and not compensatory, it would have a significant negative effect on the company's profitability and would have provided a strong incentive to challenge such rates.

⁴⁴ All RBOCs and many ILECs have adopted the FCC's ISP-bound rate of \$.0007 for their interconnection agreements. For these carriers that have adopted the FCC's ISP order, this same rate is the reciprocal compensation they will charge for intra-MTA wireless traffic, VoIP traffic and local wireline traffic.

⁴⁵ See *In the Matter of Implementation of the Local Competition Provisions in the Telecommunications Act of 1996, Intercarrier Compensation for ISP Traffic*, CC Docket No. 96-98, and No. 99-68, at 6 (April 27, 2001) (remanded on other grounds, *WorldCom, Inc. v. FCC*, 288 F.3d 429 (D.C. Cir. 2002), cert. den., *Core Communications, Inc. v. FCC*, 538 U.S. 1012 (2003), subsequent mandamus, *In Re: Core Communications, Inc.*, 531 F.3d 849 (2008); order on remand, *In the Matter of High Cost Universal Support, et al*, WC Docket No. 05-337 (released Nov. 5, 2008) (emphasis supplied).

1 originating or terminating a long-distance call. So the fact that the LECs' interstate
2 switched access rates are well above the FCC's rates for local call termination (which the
3 FCC found sufficient to cover cost) confirms that the LECs' interstate switched access
4 rates are also well above any applicable measure of cost.⁴⁶

5 **2. PARITY WILL REDUCE BILLING COSTS AND**
6 **ELIMINATE HARMFUL ARBITRAGE OPPORTUNITIES.**

7 **Q. IN ADDITION TO ITS SIMPLICITY, WILL UNIFYING INTRASTATE AND**
8 **INTERSTATE SWITCHED ACCESS RATES AND RATE STRUCTURES ALSO**
9 **REDUCE LEC BILLING COSTS?**

10
11 **A. Yes.** Unified rates can reduce LEC billing costs, if for no other reason than the LECs
12 will only have one set of rates to bill instead of two. Every Arizona LEC – ILEC and
13 CLEC - already has in place interstate rates and rate structures that comply with the
14 FCC's interstate access requirements. Likewise, every LEC already has mechanisms in
15 place that enable it to track, rate and bill access customers for interstate switched access
16 services. Once a LEC reduces its intrastate switched access rates to match - in both rate
17 level and rate structure - its counterpart interstate rates, it can simply use its existing rate
18 structures and billing mechanisms to bill the matching intrastate rates. Indeed, once
19 parity is implemented, the LECs will *eliminate* the costs associated with maintaining two
20 different rate structures and billing mechanisms for the same switched access functions.

21 **Q. WILL "PARITY" BETWEEN INTRASTATE AND INTERSTATE SWITCHED**
22 **ACCESS RATES REDUCE OPPORTUNITIES FOR FRAUD AND ARBITRAGE?**

23
24 **A. Yes.** The wide disparity between interstate and intrastate access rates creates
25 opportunities and incentives for carriers to engage in "call pumping," "phantom traffic"

⁴⁶ These comparisons demonstrate that there is no need to go through the lengthy and complex processes that would be involved in calculating the actual cost of intrastate switched access service to the last fraction of a penny, as long as no party is suggesting that intrastate rates should be reduced to cost.

1 and similar arbitrage schemes. Adopting symmetrical rates and rate structures will help
2 to reduce these problems.

3 With regard to "call pumping" schemes, some local providers, spurred on by the
4 ability to benefit from high intrastate access prices, have developed processes that
5 encouraged the creation of chat rooms, adult services and other questionable services that
6 can generate high volumes of intrastate access traffic. The carriers then kick back a share
7 of their access revenues to these providers. These schemes have generated a series of
8 complaints and other litigation proceedings before the FCC and state commissions (e.g.
9 Iowa Utility Board), and recently have drawn the interest of the chairmen of three
10 separate U.S. Congressional Committees: Chairmen Waxman, Boucher, and Stupak.⁴⁷
11 These arbitrage schemes are quite serious and difficult to control under the current
12 pricing system, as AT&T has expressed:

13 "....AT&T and other are engaged in litigations with many current perpetrators for
14 their violations of existing law, but given the ease with which these schemes are
15 implemented and shifted rapidly to other locations, it is clear that after-the-fact,
16 case-by-case litigation could never fully protect the public interest...." P.1.

17
18 "Phantom traffic" is the term used to describe schemes to disguise the
19 jurisdictional nature of calls in an attempt to treat intrastate calls as interstate in order to
20 take advantage of lower interstate switched access rates. These schemes may involve
21 inefficient routing of calls, attempts to mislabel the originating points of calls, and
22 attempts to deliver traffic without sufficient information for the LEC to determine the
23 jurisdictional nature of the call.⁴⁸

⁴⁷ See AT&T Letter dated October 27, 2009 to Honorable Henry A. Waxman (Chairman, Committee on Energy and Commerce), Honorable Rick Boucher (Chairman, Sub-Committee on Communications, Technology, and the Internet), and Honorable Bart Stupak (Chairman, Committee on Oversight and Investigation) – Attached as OAO_Exhibit E.

⁴⁸ See Qwest Response to Staff Data Request STF 01-005.

1 Disputes over "call pumping" and "phantom traffic" will be reduced once
2 intrastate and interstate switched access rates are set at the same levels and share the
3 same rate structure.

4 **Q. HAVE ANY LECS AGREED THERE ARE BENEFITS TO HAVING UNIFIED**
5 **INTER- AND INTRASTATE ACCESS RATES?**
6

7 **A.** Yes. About one year ago Qwest Chairman and CEO Edward A. Mueller made the
8 following remarks before a NARUC conference:

9
10 "We need new rules that treat all minutes and all companies the same. Voice or
11 data, IP or switched, wireless or wireline, a minute is a minute and our intercarrier
12 compensation rules should treat them the same.
13 We support proposals by the FCC and others to significantly reduce terminating
14 switched access charges. These charges greatly exceed their actual costs and vary
15 greatly based upon unrelated factors, such as the type of call, the jurisdiction of
16 the call, or the identity of the carrier. Such distinctions are neither practical nor
17 rational in today's communications industry. We also believe that these changes
18 should be revenue neutral for the affected local exchange carriers through changes
19 in subscriber line charges, local rates, or other revenue replacement
20 mechanisms.... it is important that we recognize that the opportunities for
21 individual companies to exploit the existing rules -- through arbitrage [i.e. traffic
22 pumping] -- will not be eliminated until that transition is complete."⁴⁹ (emphasis
23 added).
24

25 Likewise, the ALECA members have recently suggested, in a whitepaper, that the current
26 system is unsustainable and that the Commission should reduce their intrastate rates to
27 mirror their interstate counterparts:

28
29 "In order to provide immediate Arizona access rate reform, the intrastate
30 composite rate needs to be at the level of the interstate composite rate. This
31 reduction, if taken in isolation would cause significant economic hardship on the
32 ALECA members and may cause the failure of these enterprises. This type of
33 reform can only be successful if accompanied by a revenue offset which preserves
34 revenue neutrality for rural carriers."
35

⁴⁹ Qwest Chairman and CEO Edward A. Mueller's remarks at the 120th annual National Association of Regulatory Utility Commissioners (NARUC) convention in New Orleans on Nov. 17, 2008.

1 The Commission should take the first step toward a unified switched access system by
2 adopting AT&T's proposal for intrastate-interstate parity.⁵⁰ In addition, this reform will
3 help keep the traffic pumpers out of Arizona once the incentives to engage in their scams
4 have been reduced.

5
6
7 **3. OTHER STATES HAVE ADOPTED THE SAME "PARITY"**
8 **APPROACH.**
9

10 **Q. HAVE OTHER STATES REDUCED INTRASTATE ACCESS RATES?**

11 **A.** Yes. Numerous states, including New Mexico, Massachusetts, Illinois, and Texas, have
12 mirrored reforms the FCC has already adopted. These state commissions require local
13 exchange carriers' intrastate switched access rates to mirror their interstate switched
14 access rates, and thereby have taken steps towards eliminating market distortions and
15 therefore increased competitiveness in telecommunications.⁵¹

16 Like Qwest and ALECA, Verizon also supports reform as is clear from its actions
17 in other states where it is an ILEC and where its access rates have been substantially
18 reduced. In West Virginia, for example, Verizon agreed to reduce its intrastate switched
19 access rates to interstate levels in return for the same retail local exchange pricing
20 flexibility.⁵²

⁵⁰ Although this proceeding and AT&T's proposal do not address a comprehensive unification of all intercarrier charges, it will certainly be a step in the right direction.

⁵¹ The other states include Alabama, Georgia, Indiana, Iowa, Kansas, Kentucky, Maine, Mississippi, Nebraska, Nevada, New Mexico, North Carolina, Ohio, Oklahoma, Oregon, Tennessee and Wisconsin. Citations to the statutes or commission policies implementing such policy changes are listed in OAO Exhibit F.

⁵² Petition by Verizon West Virginia Inc., Bell Atlantic Communications, Inc., dba Verizon Long Distance, MCIMetro Access Transmission Services LLC, dba Verizon Access Transmission Services, and MCI Communication Services Inc., dba Verizon Business Services requesting that Commission initiate a general investigation of the intrastate switched access charges of competitive local exchange carriers operating in WV and motion for confidential treatment of certain information provided under seal, April 25, 2008, at pages 3-4.

1
2 **ISSUE 3 – WHAT PROCEDURES SHOULD THE COMMISSION IMPLEMENT TO**
3 **ACHIEVE THE DESIRED REDUCTION IN ACCESS RATES?**

4 **Q. WHAT PROCEDURES SHOULD THE COMMISSION IMPLEMENT TO**
5 **ACHIEVE THE REDUCTION IN INTRASTATE ACCESS RATES?**
6

7 A. This is a legal issue which our counsel will address in briefing. But, as I understand it, we
8 recommend that the Commission require all incumbent local exchange carriers, no later
9 than 60 days after the effective date of necessary revisions to the AUSF rules approved in
10 this Order, to reduce their intrastate switched access rates to the ILECs' interstate rate
11 structures and levels and, within 60 days of the date of this order, require all CLECs to
12 adjust their intrastate tariffs so that their access charges do not exceed those assessed by
13 the ILEC in whose territory they operate. Each ILEC should also be directed to update
14 and mirror its intrastate tariff anytime it changes its interstate rates in the future and
15 CLECs should file conforming changes to match those of the ILEC with which they
16 compete.

17
18
19 **Q. WHAT IF AN ILEC OR A CLEC DOES NOT MAKE THE REQUIRED FILINGS**
20 **TO ADJUST THEIR INTRASTATE ACCESS RATES AS YOU HAVE**
21 **DESCRIBED?**
22

23 A. Again, this is a legal issue which we will address in briefing, but I understand our
24 position to be that the Commission should institute an Order to Show Cause against any
25 carrier which does not make such a filing as to why their intrastate rates should not be
26 reduced.

1
2 **ISSUE 4 - SHOULD CARRIERS BE PERMITTED TO CONTRACT FOR ACCESS**
3 **RATES THAT DIFFER FROM THEIR TARIFFED RATES?**

4 **Q. SHOULD THE COMMISSION PERMIT CARRIERS TO CONTRACT FOR**
5 **ACCESS RATES THAT DIFFER FROM TARIFFED RATES?**

6 A. Unquestionably, yes. But first, like Issue 3 this is also a legal matter that our counsel will
7 address in AT&T's brief. I provide only an economic perspective as follows. The
8 "parity" approach I described above is a straightforward step that this Commission can
9 take quickly, and it makes a good general rule for all LECs. Parity will make significant
10 progress in reducing implicit subsidies, and it will generate significant benefits for
11 consumers and competition. But parity is not designed to be a *complete* reform, nor is it
12 designed to eliminate implicit subsidies *entirely*. The FCC or the Commission may
13 decide to implement additional reforms later. But in the meantime, individual companies
14 should be allowed to develop and negotiate additional reforms on their own, and they
15 should be allowed to enter into contracts that give them the opportunity to react to
16 changing market conditions. Generally, it takes a relatively long time to arrive at a
17 regulatory solution (months or years depending on the complexity of the issues involved).
18 Sometimes it takes several years to even begin an investigation. Therefore, during the
19 periods between regulatory reviews, companies may suffer undue economic harm if not
20 allowed the flexibility to derive business solutions in form of mutual agreements to help
21 them avert potential losses.⁵³

⁵³ For example, it has been eight years since the FCC initiated investigation into further interstate access reform and more than four years since it initiated its ongoing comprehensive investigation of intercarrier compensation. See In the Matter of Developing a Unified Intercarrier Compensation Regime, Federal Communications Commission, *Further Notice of Proposed Rulemaking*, FCC 05-33, Mar. 3, 2005. Likewise, the Arizona access proceeding was initiated as far back as 2000.

1 While contracts may provide additional relief, a generic ruling that applies to all
2 carriers is still necessary to establish just and reasonable prices that will apply when
3 separate agreement is not reached. For a non-competitive service like switched access, a
4 generic ruling is needed to protect access buyers from the LECs' natural desire to exploit
5 their market power and charge excessive access rates. With a general pricing rule in
6 place, additional stability is ensured when no separate contract exists between parties.
7 Further, a generic ruling is more efficient in the long run given the number of companies
8 operating in the market and the transaction costs involved in negotiating a contract with
9 everyone.⁵⁴

10 **D. ACCESS REFORM WITH REVENUE NEUTRAL**
11 **REBALANCING WILL PROTECT AGAINST REVENUE**
12 **LOSSES, ALIGNS ECONOMIC INCENTIVES WITH**
13 **CONSUMER PREFERENCES, AND PROMOTE**
14 **BROADBAND ADOPTION IN ARIZONA.**

15
16 ***ISSUE 5 - WHAT REVENUE SOURCES SHOULD BE MADE AVAILABLE TO***
17 ***CARRIERS TO COMPENSATE FOR THE LOSS OF REVENUES?***

18 **Q. SHOULD CARRIERS BE ALLOWED TO RECOVER THE REDUCTION OF**
19 **ACCESS REVENUES THAT WILL RESULT FROM ACCESS CHARGE**
20 **REFORM?**

21 **A.** Yes. The Commission should allow carriers to recover lost access revenue by increasing
22 their retail rates for local service, and in certain cases, by drawing revenue replacement
23 from the state universal service fund. This proposal will be implemented in two steps.
24 First, the Commission should give all carriers the opportunity to increase retail rates for
25 local service up to a "benchmark" established by the Commission (to the extent they do

⁵⁴ This is not unusual, as telephone companies often try to avoid the rigidity of tariffs by including provisions that enables Individual Case Basis (ICB) contracts so that they can be able to respond quickly to their customer needs in a fashion that accommodates the going business concerns. Although the access related contracts may be different because they pertain to a wholesale service, the concept is similar in that it generally enables businesses the flexibility to respond, when necessary, to market circumstances.

1 not already have that flexibility); however, the Commission should not require carriers to
2 raise local service rates by any amount. Rather, the actual decision to raise price, and the
3 amount (within the constraints of the benchmark cap), should be left to the carriers as
4 they are best positioned to make decisions about their own businesses.

5 For the second step, to the extent that the "benchmark" rate is not sufficient for a
6 qualifying LEC to recover all of that LEC's access reductions, that LEC would be
7 eligible to receive support from the Arizona universal service fund (AUSF) and its level
8 of support will be determined as if it had raised its retail local rate up the benchmark
9 level.

10 **Q. WHY IS IT APPROPRIATE TO GIVE CARRIERS THE FLEXIBILITY TO**
11 **INCREASE RETAIL RATES FOR LOCAL SERVICE?**

12 A. The flexibility to restructure prices is part of effective access reform. As discussed
13 earlier, high access rates under the monopoly regime were established to promote
14 universal service objectives: retail prices for local service were held at artificially low,
15 below-cost levels, and access rates were, in turn, set high to offset the shortfall. Thus, it
16 makes perfect sense that as access charges are reduced, the Commission should also relax
17 the restrictions on retail prices that were the other side of the access trade-off to an extent.
18 That will allow local service prices to rise to more realistic levels and balance out the
19 potential access revenue reduction.

20 Moreover, giving carriers the flexibility to adjust retail prices creates the right consumer
21 incentives because it gives consumers the correct price signal – one that better reflects the
22 underlying cost of service. If retail prices for traditional switched local service are held at
23 artificially low, below-cost levels, consumers will demand more of that service than they

1 otherwise should, and as discussed earlier companies decisions to invest in the alternative
2 technologies will be distorted by artificial (incorrect) price signals that are not based on
3 society's real cost. Therefore, giving carriers the flexibility to increase prices will
4 encourage consumers to use the right quantity of the previously subsidized service once
5 the true costs are revealed. It also encourages consumers to use the right quantities of
6 alternative services like broadband, based on merits, and companies are incented to invest
7 in a manner that better reflects consumer preferences.⁵⁵

8 That said, I want to reiterate that I am not advocating that the Commission
9 *mandate* any price increases: it should simply reduce the old artificial restrictions and
10 give carriers the flexibility to increase retail prices. In addition, the Commission can still
11 achieve universal service goals. As I stated earlier, price increases would still be limited
12 to an reasonable "benchmark" and, to the extent any ILEC needs additional support to
13 make up for the reduction in the legacy access subsidies, AT&T is proposing that the
14 ILEC be eligible to receive access replacement support from the Arizona universal
15 service fund.

16 **Q. WHAT ARE THE RISKS IN TAKING NO ACTION?**

17 A. As I stated earlier, the present scheme (where some LECs charge extraordinarily low
18 (below-cost) retail rates for local service while they collect implicit subsidies from
19 extraordinarily high access rates) cannot be sustained. As consumers and the industry
20 continue to migrate from the traditional public switched telephone network ("PSTN")
21 towards alternative systems of delivering telecommunications (which includes

⁵⁵ For additional detail about how incentives for investment are affected by excessive access rates, see Dr. Aron direct testimony, Section VI (D).

1 broadband), the sources for these subsidies will shrink and eventually disappear.

2 Ironically, the system that was initially designed to help consumers stay connected to the
3 traditional network may be creating an unsustainable situation where consumers' ability
4 to connect to the new network is threatened. Without action the system that the access
5 subsidies were intended to support appear to be headed for a collapse.

6 **Q. WOULD THE LECS BE HARMED IF ACCESS REDUCTIONS ARE REVENUE**
7 **NEUTRAL?**

8 A. No, almost by definition. As discussed above, the Commission should allow the ILECs
9 to recover lost access revenues by first granting them additional retail rate flexibility up
10 to a "benchmark" rate. To the extent the benchmark rate is not enough for any particular
11 ILEC to recover all of its access revenue reductions, the ILEC would be eligible for
12 universal service support. That way, ILECs will still have the opportunity to collect the
13 same revenues and recover the cost of providing local service, just from more
14 competitively neutral sources: the local service customers that cause that cost to be
15 incurred and the AUSF (which would be broadly funded), rather than from wireline IXCs
16 and their customers.

1 **ISSUE 6 – HOW MUCH OF ACCESS COST RECOVERY, IF ANY, SHOULD BE**
2 **SHIFTED TO END USERS? WHAT SHOWING SHOULD BE REQUIRED FOR**
3 **SUCH A SHIFT? WHAT SHOULD BE THE ROLE OF “BENCHMARK” RATES**
4 **AND HOW SHOULD THE BENCHMARKS BE SET?**

5 **Q HOW MUCH OF ACCESS COST RECOVERY, IF ANY, SHOULD BE SHIFTED**
6 **TO END USERS?**

7 A. As much as will allow retail rates to be more reasonable and reveal the true cost of
8 service to consumers. Dr. Aron explains why recovering forgone access revenues from
9 end users increases efficiency and promotes competition. But I discuss here specifically
10 how retail rate flexibility can be implemented in a revenue neutral manner, and still
11 increase efficiency or promote competition as Dr. Aron suggests. As discussed earlier,
12 carriers will be allowed the opportunities to increase their retail rates up to a benchmark
13 set by the Commission. The difference between the old retail rates and the benchmark
14 (i.e. the amount of increase per line) times the carrier's line count represents the amount
15 that might be recovered from end users. Note, however, that under AT&T's proposal
16 carriers would not be *required* to increase their rates by any amount; it is up to the
17 carriers to decide how much of the *allowed* rate increases they will actually implement.

18 **Q. HOW SHOULD THE COMMISSION DETERMINE THE BENCHMARK?**

19 A. Dr. Aron describes the guidelines for an effective benchmark.⁵⁶ Specifically;
20 (1) the Commission should set this policy now as part of AUSF rule changes which
21 would be necessary for the ILECs to rebalance part of their access reductions;
22 (2) the Commission should ensure that, *first*, the benchmark allows as much cost
23 recovery from end users as possible subject to affordability concerns. This will

⁵⁶ See Dr. Aron Direct Testimony, Section VI(D).

1 encourage the right consumer incentives and at the same time limit the amount of
2 recovery to be obtained from the AUSF, so that fund contributions are not increased too
3 dramatically,⁵⁷

4 (3) the gap between urban and rural retail rates should be narrowed⁵⁸ in accordance with
5 Congressional guidance that rates should be reasonably comparable for similar services
6 in urban and rural areas,⁵⁹ and since such artificial disparity cannot be sustained going
7 forward as the current system transforms into a subsidy-free broadband system.

8 A couple of possibilities are a benchmark based on the highest urban retail rates in
9 Arizona, or on the weighted average retail rates of ILECs in Arizona, increased by a
10 factor⁶⁰ (e.g. 125 percent as suggested by Qwest).⁶¹ For illustration, the highest urban
11 retail residential rate of \$13.18 is assessed by Qwest and if one applies Qwest's suggested
12 factor of 125 percent, the benchmark would be \$16.48. Alternatively, if the Commission
13 were to start with the weighted average residential retail rate of \$13.16 (i.e. retail rates
14 and line counts from 14 Arizona ILECs), and applying the adjustment factor of 125
15 percent would yield a hypothetical benchmark of \$16.45.⁶² As I explain below, these

⁵⁷ Often, when issues regarding universal service fund are being discussed, there is a tendency to forget that its source, as a Pennsylvania ALJ recently concludes, "...is not *free money* to be plundered at will and without concern for its origins or for whether it is the best use of the money." See Recommended Decision of PA PUC Administrative Law Judge Susan D. Colwell, in "Investigation Regarding Intrastate Access Charges and IntraLATA Toll Rates of Rural Carriers and the Pennsylvania Universal Service Fund, Docket No. I-00040105. (emphasis added).

⁵⁸ Providers should look to their own end users and recover their costs through higher end-user rates and the USF should be used only to support carriers serving low income customers and high cost areas where cost-based rates would exceed a benchmark.

⁵⁹ See 47 U.S.C. § 254(b)(3).

⁶⁰ According to Qwest, increasing Qwest's rate by 125 percent will ensure that the urban rural retail rates are comparable. See Qwest Response to Staff Data Request STF 01-013.

⁶¹ Qwest suggests that its retail rates should be increased by 125 percent to set a benchmark. See Id.

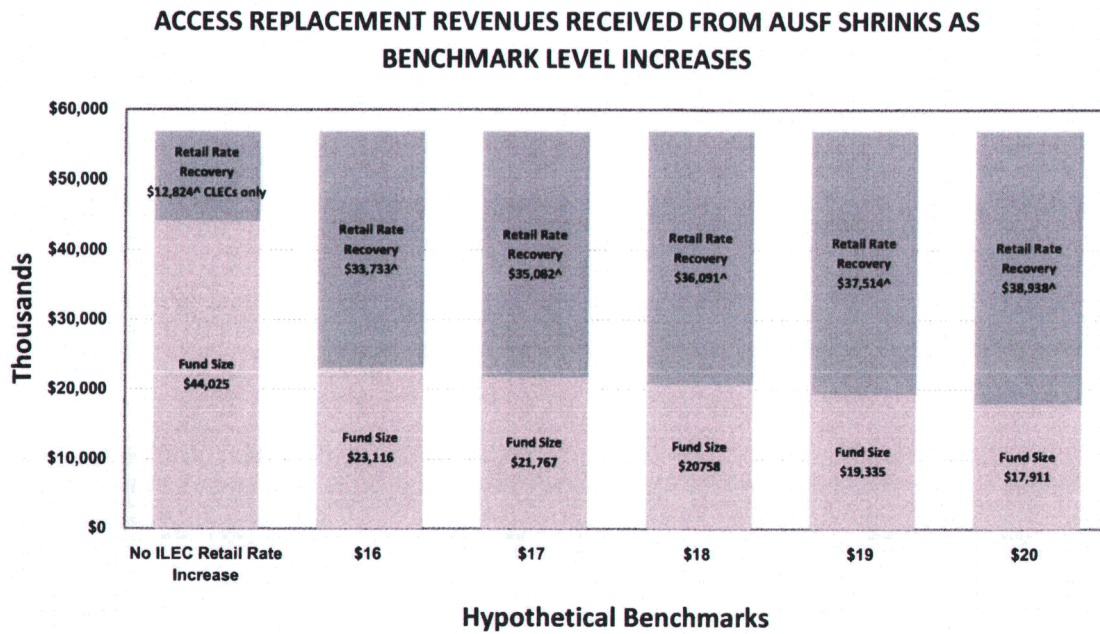
⁶² Since the Qwest urban rate and Arizona's state-wide weighted average are below the national average residential rate of \$15.62, AT&T believes that either \$16.34 or \$16.48 represents the low end of a reasonable range of benchmark levels. See FCC's Reference Book of Rates, Price Indices, & Household Expenditures for Telephone

1 figures are quite reasonable, and in fact represent the low end of a reasonable range of
2 possible benchmarks.

3 To minimize demands on the AUSF, the Commission should adjust the initial
4 benchmark for inflation or by any other reasonable amount. The following chart
5 illustrates that the AUSF fund size will decrease as the benchmark level is increased:
6

1

Figure 4



Notes:

Based on Responses to Data Request.

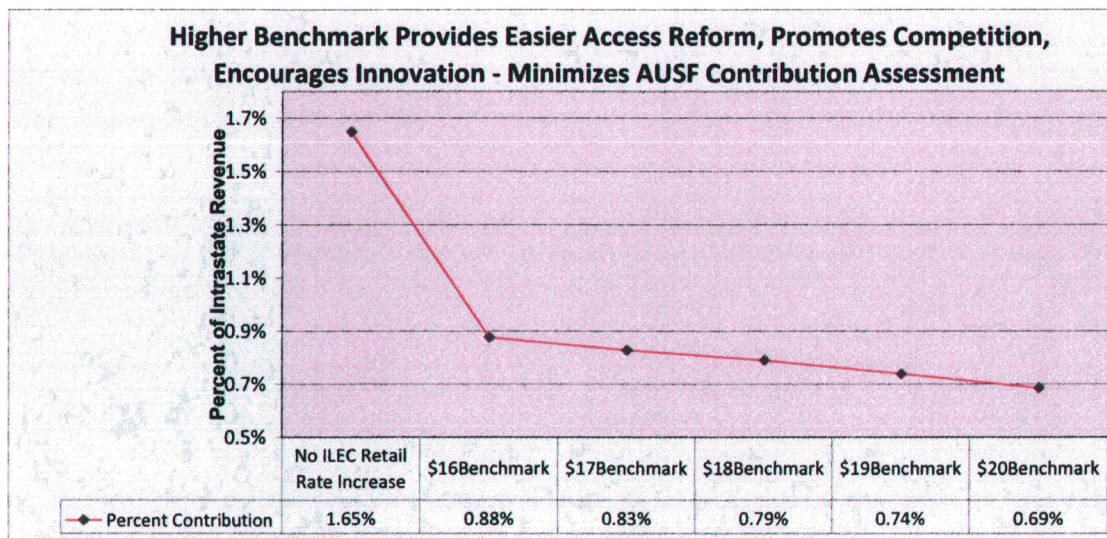
Benchmark Ranges are Hypothetical samples for illustration purpose only. Commission will set final benchmark.

[^] Retail Rate Recovery - means amount that could be recovered by increasing retail local exchange rates. ILECs are assumed to have flexibility to increase retail local rates up to benchmark, but are not mandated to do so. CLECs should have sufficient retail rate flexibility to allow full recovery from end-user retail rate increase.

2

Likewise, the contribution impact (i.e. amount of contribution assessment to telecommunications provider and their customers) will decrease as the benchmark level increases. This is illustrated by the next chart:

Figure 5



Notes:

1). Based in part on analysis of access revenue reduction and access replacement requirement as illustrated in Figure 4 above.

2). Benchmark Ranges are Hypothetical samples for illustration purpose only. Commission will set final benchmark.

3). % Assessment (Contribution) = Total 12 month AUSF Fund Requirement ÷ Total 12 month Arizona retail intrastate telecommunications service revenues.

4). Intrastate Revenue from FCC Monitoring Report, released December 2008, Table 1.15 Intrastate Telecommunications Revenues: 2006 End-User

Q. WILL BASIC SERVICE REMAIN AFFORDABLE IF RETAIL RATES ARE ALLOWED TO INCREASE TO THE "BENCHMARK" AMOUNT QWEST SUGGESTS?

A. Absolutely: in fact, Qwest's suggestions would yield a benchmark at the low end of a reasonable range. In most instances, rates would increase to levels that still fall below what they would have been if they had just kept up with inflation since the last time those rates were changed. An AT&T analysis of fourteen Arizona ILECs (based on publicly

1 available data) reveals that the weighted average inflation adjusted retail rates for
2 residential local service would be \$17.50 compared with the \$13.16 paid today, on
3 average.⁶³ This means, as a practical matter, if one of the benchmarks identified above
4 were adopted, each customer's price for service in real terms (that is, adjusted for
5 inflation) would not have changed.

6 In addition, the benchmark proposed by Qwest is consistent with or below those
7 set by other states; for example, New Mexico's benchmark is \$13.86⁶⁴, Indiana has a
8 \$17.15 benchmark for residential basic local service (\$23.60 for single line business),
9 Pennsylvania's benchmark is \$18,⁶⁵ and New York has a \$23.00 rate cap. In Alaska, a
10 benchmark of \$25.00 has been proposed by Alaska Commission Staff and would increase
11 by \$5.00 annually until it reaches \$40.00.⁶⁶ Also, end users across the country pay \$50.00
12 or more on bundled packages and other services from newer technologies such as
13 wireless and broadband where prices are free of subsidies.⁶⁷

14 To further illustrate the reasonableness of these benchmarks, consider a
15 benchmark of \$18. Based on my preliminary analysis, the rate rebalancing required to
16 bring retail rates of most LECs (excluding the CLECs) to an \$18 (a round number chosen

⁶³ With inflation, the adjusted retail rates calculations range from \$11.89 to \$29.49 for residence and \$22.44 to \$57.15 for business.

⁶⁴ This initial benchmark was established by New Mexico Commission's order dated April 15, 2004 where the Commission indicated the benchmark may be re-determined every three years. As of the filing of this testimony, I have not been able to determine if such review had occurred. In the Matter of a Notice of Inquiry to Develop a Rule to Implement House Bill 776, Relating to Access Charge Reform, Case No. 05-00211-UT, Order Dated April 15, 2004, page 12.

⁶⁵ A Pennsylvania ALJ has recently recommended to the PA PUC that the \$18 retail rate cap should be removed so that ILECs will have unlimited pricing flexibility.

⁶⁶ Regulatory Commission of Alaska, Staff's Memorandum, July 13, 2009, page 22.

⁶⁷ According to a GAO report, bundled packages which contain television, High-Speed internet, and local telephone has been the preferred business strategy by Broadband Services Providers and these bundles can be offered at an average discounted price of \$117.28, while the High-Speed internet portion alone (if purchased a la carte) could cost as much as \$55.46 on average. See U.S. General Accounting Office Report to U.S. Senate Subcommittee on Antitrust, Competition Policy and Consumer Rights, Committee on the Judiciary, titled, "Wired-Based Competition Benefitted Consumers in Selected Markets," February 2004, page 12.

1 for illustration) benchmark level will offset about \$36 Million out of the total \$56 Million
2 access revenue reductions that that will result if all LECs reduced their intrastate access
3 rates as AT&T proposes here. This would cause retail local rates to rise, on statewide
4 average, by no more than \$1.58 per line per month⁶⁸, and result in a weighted Arizona
5 average residential rate no more than \$15.00 per line per month:⁶⁹ Plainly, Qwest's
6 suggested benchmarks (approximately \$16.50), are significantly lower than reasonable
7 range:⁷⁰

⁶⁸ For Qwest and the CLECs, a retail rate increase of no more than \$1.00 will be sufficient to recover all access revenue that will be forgone if the Commission reduced their intrastate access rates to the interstate target. The ALECA companies will need an average of \$12.11 per line per month in additional revenue to be revenue neutral, and \$10.58 can be recovered from their retail rate flexibility opportunities up to the \$18.00 benchmark, if adopted by the Commission. They will then receive access replace support for the balance of \$1.54 per line per month from the AUSF.

⁶⁹ CLECs should the allowed unlimited retail rate flexibility, and they would not be subject to the proposed benchmark

⁷⁰ CLECs should the allowed unlimited retail rate flexibility, and they would not be subject to the proposed benchmark

Table 1

[BEGIN CONFIDENTIAL INFORMATION]



[END CONFIDENTIAL INFORMATION]

As the table above demonstrates, a statewide weighted average increase of \$1.58 per line would still leave retail rates below where they would have been had they been allowed to increase by inflation since the tariff effective dates. Keep in mind that carriers will not be *required* to raise their rates all the way up to the benchmark, or by any amount. Because these ILECs face substantial competition from cable, wireless, VoIP providers and others, the extent to which rates would actually rise is likely to be constrained by the threat of competition. The Commission can rest assured, therefore that retail customers have the

option to choose alternatives if they think a LEC's new prices are not consistent with real value. In other words, unlike in the case of switched access (where access buyers have no real choice among sellers), market forces in the local retail market will eventually determine what retail rate level will prevail. It is then up to the LECs to react in whatever way they think best in their business judgment; e.g. increase price, improve efficiencies, or expand the scope of their product offerings to generate new revenues.⁷¹

Q. WHAT TYPES OF DATA SHOULD CARRIERS PROVIDE TO CALCULATE THE AMOUNT OF REVENUE REPLACEMENT TO BE DRAWN FROM AUSF?

A. To recover any access replacement revenue from the AUSF, a carrier should be required to provide a report that identifies (1) the amount of its switched access reduction,⁷² (2) the amount of revenue it would recover if it raised its retail rates to the benchmark level,⁷³ and (3) the net funding for which it qualifies i.e., the amount of its switched access reduction in (1) less the amount it would recover if it raised its rates to the benchmark level in (2).

Q. SUPPOSE HYPOTHETICALLY THAT THE BENCHMARK WOULD GIVE A PARTICULAR LEC THE FLEXIBILITY TO INCREASE LOCAL SERVICE RATES BY \$10.00 PER MONTH. ARE YOU SUGGESTING THAT THIS INCREASE SHOULD OCCUR IMMEDIATELY?

A. No. Intrastate access rates should be reduced immediately to intrastate levels, so that consumers can benefit as soon as possible from the lower long distance prices that would be expected to result. Regarding retail prices for local services, to make for a smoother

⁷¹ The benchmark process proposed herein only suggests that the ILECs must be given an opportunity to offset access reductions; it is not a mandate that they do so. Those decisions are left to the ILECs.

⁷² Specifically, access reduction will be calculated as: the product of the difference of Intrastate Rate Less the Interstate Rate (Target Rate) Times the annual Intrastate Minutes of Use. That is,

$$\text{Intrastate Rev. Loss} = (\text{Intrastate Rate} - \text{Interstate Rate}) \times (\text{Annual Intrastate MOU})$$

⁷³ To calculate this figure, a carrier would, i) collect the number of lines as of year-end the most recent calendar year prior to when the report is being prepared; ii) multiply the line count figure in (i) by the difference between current retail rate and the benchmark to derive the incremental retail revenue.

1 transition in such cases, the Commission can phase the benchmark in over a period of
2 time by setting a maximum annual price increase. Under this approach, an ILEC would
3 only have the opportunity to increase its monthly retail rate by a maximum of \$2.00 per
4 line and charge that new monthly rate for one year. Using the hypothetical \$10.00 retail
5 rate increase as an example, the Commission would give an ILEC flexibility to increase
6 its local retail rate by only \$2.00 per year until it reaches the benchmark. During this
7 phase-in period, any remaining access reduction that the LEC is not able to recover
8 through the retail rate increase could be drawn from AUSF access replacement fund I
9 discuss in more detail below. Of course, the AUSF support would be phased down each
10 year as the LEC is able to increase its local rates by an additional increment of \$2.00 per
11 line.⁷⁴

12 **Q. PLEASE PROVIDE EXAMPLES TO ILLUSTRATE HOW THIS COULD**
13 **WORK?**

14 A. I have prepared a set of hypothetical illustrations that assume a benchmark of \$18.00, and
15 a \$2.00 maximum annual increase allowed. For each of these three illustrations, I look at
16 two time periods: "Step 1," which occurs 60 days following the effective date of the
17 revised AUSF rules; and "Step 2," which occurs on the same date one year later. All
18 Arizona ILECs would be required to reduce their switched access rates to interstate parity
19 at Step 1.

20 Case #1 (an ILEC)

- 21 • The ILEC's access revenue reduction equals \$6.00 per line per month (i.e. total
22 reduction in access revenue, divided by the carrier's total line count)

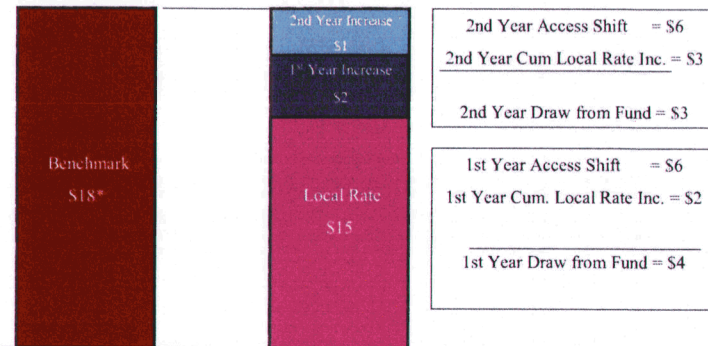
⁷⁴ Once all carriers retail rate have been increase up to the benchmark such that no ILEC has any more flexibility, and suppose the Commission still desires to reduce the fund size the benchmark level could be raised annually like in the Alaska staff's recommendation to the Alaska Commission, i.e. that the benchmark level should increase by \$5.00 annually until it reaches \$40.00.

- 1 • The ILEC's current retail rate is \$15.00 per month. Thus, the ILEC would be
2 allowed to increase its rates up to the \$18.00 benchmark and recover up to \$3.00
3 per line from end users, but subject to the maximum annual increase of \$2.00 on
4 the monthly rate.
- 5 • At Step 1, access reform takes effect immediately, and the ILEC's access
6 revenues will be reduced by \$6.00 per line.
- 7 • At this step, the ILEC will have the opportunity to increase its retail rate by
8 \$2.00, the maximum annual price increase allowed under the "phase in"
9 approach.
- 10 • The ILEC will then have the opportunity to draw support from the AUSF. Also at
11 Step 1, the carrier would be eligible for \$4.00 per line per month in AUSF
12 support (the \$6.00 per-line reduction in access revenues, minus the \$2.00 the
13 carrier is allowed to obtain through the above increases in retail local service
14 rates). Note that this is true even if the ILEC chose not to raise rates by the full
15 \$2.00 per line.
- 16 • At Step 2, the carrier has additional flexibility to increase its local service rates
17 by another \$1.00, to reach the \$18.00 benchmark level. The \$2.00 per-year
18 maximum increase under the phase-in plan is no longer a consideration, because
19 the carrier's retail rate can reach the benchmark level without an increase of
20 \$2.00 or more.
- 21 • Again in Step 2, the carrier will be eligible for \$3.00 per line in support from the
22 AUSF: the portion of the \$6.00 per-line access revenue reduction that is not
23 recovered by the \$3.00 in retail rate increases allowed at Steps 1 and 2 combined.

24 I illustrate this Case 1 scenario graphically in the chart below.

Figure 6

ILECS DRAWING FROM THE ACCESS REPLACEMENT FUND
CASE #1 - RATES BELOW BENCHMARK



*The ACC may decide that the recommended \$18 benchmark should be higher or lower



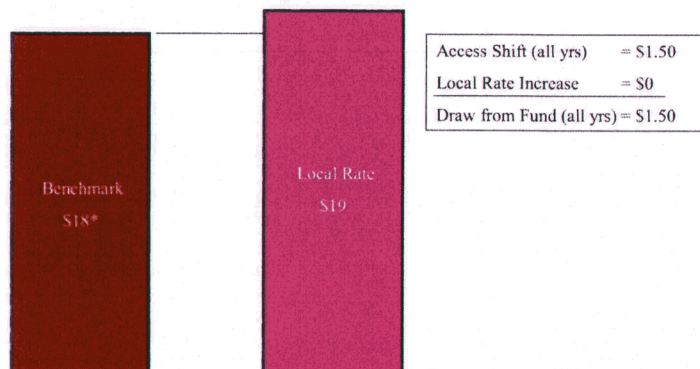
Case #2 (an ILEC)

- The ILEC's access reduction (or shift) equals \$1.50 per line per month (i.e. total amount of access reduction divided by the ILEC's total line count)
- The ILEC's current retail rate is \$19.00 per month. Because the ILEC's rate is already above the \$18.00 benchmark, it will not receive any flexibility to raise its rates further, and will instead have to recover the total access reduction of \$1.50 per line from the AUSF Access Replacement Fund.
- As before, access reform takes effect immediately at Step 1.
- The ILEC's retail rate remains the same at \$19.00 per month.

I illustrate Case 2 scenario by the chart below.

Figure 7

ILECS DRAWING FROM THE ACCESS REPLACEMENT FUND
CASE #2 - RATES ABOVE BENCHMARK



*The ACC may decide that the recommended \$18 benchmark should be higher or lower



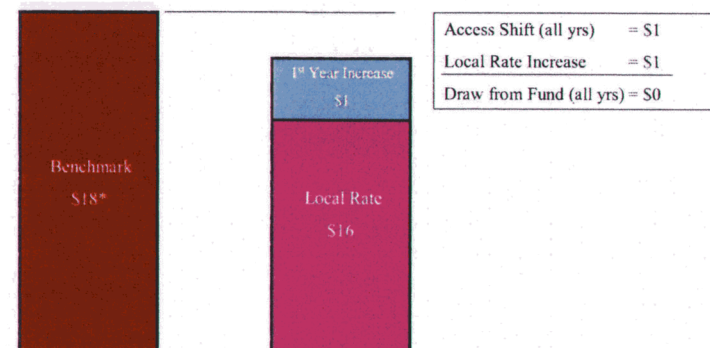
Case #3 (an ILEC)

- The ILEC's access reduction (or shift) equals \$1.00 per line per month (i.e. total amount of access reduction divided by the ILEC's total line count)
- The ILEC's current retail rate is \$16.00 per month.
- At Step 1, access reduction takes effect immediately and the carrier will have the opportunity to increase its retail rates to recover its lost revenue. Because the access revenue reduction works out to only \$1.00 per line per month, the ILEC may increase its retail rate by the full \$1.00, because the new rate of \$17.00 will still be below the \$18.00 benchmark, and the \$1.00 increase will still be below the maximum annual price increase of \$2.00.
- In this case, the carrier can elect to increase its retail rate to \$17.00, but it would not be eligible for any AUSF Access Replacement Fund support because its retail rate flexibility is sufficient to recover its total access revenue reduction in a revenue neutral manner.

The Case 3 scenario is shown in the chart below.

Figure 8

ILECS DRAWING FROM THE ACCESS REPLACEMENT FUND
CASE #3 - RATES BELOW BENCHMARK, NO DRAW FROM FUND



*The ACC may decide that the recommended \$18 benchmark should be higher or lower



1 **ISSUE 7 – PROCEDURALLY WHAT WILL BE REQUIRED OF A CARRIER IF IT**
2 **SEEKS A “REVENUE NEUTRAL” INCREASE IN LOCAL RATES?**

3
4 **Q. HOW SHOULD THE COMMISSION DETERMINE THE RETAIL RATE**
5 **INCREASE IS REVENUE NEUTRAL?**

6
7 A. At a minimum, effective implementation of access reform would involve the following
8 steps.

9 At step 1, the amount of access reduction will be determined using the carrier’s 1)
10 *intrastate* originating and terminating switched access minutes and revenue billed to
11 other providers (excluding billing to affiliates, if any) for the most recent full calendar
12 year prior to its request; and 2) *interstate* originating and terminating switched access
13 minutes and revenue billed to other providers (excluding billing to affiliates, if any) for
14 the most recent full calendar year prior to its request. The access reduction will be
15 calculated by taking the difference between the average per-minute intrastate rate
16 (intrastate switched access revenue divided by intrastate switched access minutes) and the
17 average per-minute interstate rate (interstate revenue divided by interstate minutes), and
18 then multiplying that difference by the intrastate switched access minutes.

19 At step 2, the carrier will determine the amount of additional revenue available to
20 it from local rate flexibility. To determine this amount, the carrier must provide: 1) the
21 current rate, 2) the benchmark rate, and 3) the demand quantity (e.g. number of lines, not
22 including lifeline) in the most recent full calendar year for each service that would be
23 affected by the increase. The carrier would then calculate the total amount of additional
24 revenue that would be expected if it raised rates up to the benchmark level, by taking the
25 difference between the benchmark rate and the current rate and then multiplying that
26 difference by the ILEC’s most recent line count (excluding lifeline).

1 At step 3, the carrier would compare the revenue opportunity (calculated in step
2 2) with the access revenue reduction (calculated at step 1) to determine if additional
3 support would be required from the AUSF to offset the access revenue reduction. The
4 carrier must also prove that the total of incremental revenue from its retail rate increase
5 and its draw from the AUSF (combined) is not greater than the amount of access
6 reduction. If it is, the amount of distribution from the fund will be decreased to the level
7 at which it would be just sufficient to offset the access revenue reduction (in other words,
8 any retail rate increases should first have the effect of reducing the ILEC's eligible AUSF
9 support).

10 The retail rate increase opportunity should leave end-user rates at or below the
11 benchmark and should not produce additional revenues greater than the amount of access
12 revenue the carrier lost. Procedurally, carriers would implement the rate increase by filing
13 tariff changes to increase other rates, together with data demonstrating the overall
14 revenue neutrality of the decrease in intrastate access revenues compared to the revenues
15 to be received from the tariff changes.

16 These AUSF procedural steps should only apply to ILECs, and not the CLECs.
17 As I explain under Issues 8 and 9, only ILECs should be eligible to draw support from the
18 AUSF Access Replacement Fund. CLECs should, of course, be given the retail rate
19 flexibility needed to compensate for access revenue reductions (to the extent they do not
20 already have it).

1 **ISSUE 8 - ASSUMING THAT AUSF FUNDS WILL ALSO BE USED AS A**
2 **COMPENSATING REVENUE SOURCE FOR REDUCTIONS IN SWITCHED**
3 **ACCESS REVENUES, WHAT SPECIFIC REVISIONS (INCLUDING SPECIFIC**
4 **RECOMMENDED AMENDMENT LANGUAGE) TO THE EXISTING RULES ARE**
5 **NEEDED TO ALLOW USE OF AUSF FUNDS FOR THAT PURPOSE?**
6

7 **Q. YOU STATED EARLIER THAT THE AUSF MUST BE RESTRUCTURED TO**
8 **ENABLE THE REVENUE NEUTRAL REBALANCING OF THE CARRIERS'**
9 **ACCESS REDUCTIONS. PLEASE DESCRIBE WHAT CHANGES MUST BE**
10 **MADE.**
11

12 **A.** To the extent the Commission decides to give carriers the ability to use the AUSF for the
13 access revenue replacement described under Issues 6 and 7, the Commission needs to
14 revise the existing AUSF rules. The current AUSF rules do not clearly authorize the use
15 of AUSF support to recover reductions in access revenues, nor are they designed to
16 collect contributions to fund support for that purpose. The revisions needed would
17 consist of at least the following: (i) a provision that allows eligible carriers to receive
18 support for the lost switched access revenue, specifically describing how the amount to
19 be drawn would be calculated, and identifying the supporting documentation that the
20 eligible carrier must provide in order to qualify for a revenue replacement support;
21 (ii) provisions describing the contribution methodology, the sources of contributions to
22 the fund, and provision that provides carriers an option to recover their contribution
23 assessment through a surcharge;⁷⁵ and (iii) lastly a provision that specifies eligibility
24 criteria for carriers to draw access replacement fund. AT&T will file specific AUSF
25 rules language with its reply testimony after it has reviewed other parties' direct
26 testimony on these issues.
27

⁷⁵ Contribution methods and surcharge calculation are explained in further detail later in Issue 11.

1 **ISSUE 9 – WHICH CARRIERS SHOULD BE ELIGIBLE FOR AUSF SUPPORT?**

2 **Q. SHOULD ILECS AND CLECS BE TREATED THE SAME? SHOULD ALL**
3 **CARRIERS BE ALLOWED TO DRAW REVENUE REPLACEMENT SUPPORT?**

4
5 **A.** No. CLECs do not need to receive access replacement revenue from AUSF, because, as
6 discussed earlier CLECs should have the opportunity to increase retail rates, and if
7 necessary, they should be authorized to increase their maximum price level adequately to
8 allow them to remain revenue neutral after their access rates are reduced.

9 Only ILECs should be eligible for access replacement AUSF revenue and the
10 amount distributed should be determined after considering the amount of revenue that
11 would be available if they increased retail rate up to the benchmark level. As I described
12 earlier, the ILECs' access charges were designed to provide additional revenues that
13 implicitly subsidized prices for basic local service in rural and high-cost areas, in
14 particular to incumbent local carriers who had (and continue to have) universal service
15 obligations to be ready, willing, and able to serve certain residential customers
16 throughout their respective service territories.

17 These implicit subsidies, however, can no longer be relied upon to support an
18 ILEC's provision of universal service in Arizona. To ensure that the State continues to
19 achieve its universal service objectives, the Commission should supplement ILEC rate
20 increases to a benchmark with explicit support through the Arizona Universal Service
21 Fund.

22 By contrast, CLECs stand in a very different position from the ILECs. They have
23 never been subjected to any legacy system that created implicit subsidies for universal
24 service objectives, they could determine which geographic areas to serve, and they have

1 been given the opportunity to price their services under a more flexible system than
2 existed traditionally for the ILECs, and one they felt allowed them best to be successful
3 in the competitive marketplace.

4 ***ISSUE 10 – WHAT SHOULD BE SUPPORTED BY AUSF? ACCESS***
5 ***REPLACEMENT ONLY? HIGH COST LOOPS? LINE EXTENSIONS?***
6 ***CENTRALIZED ADMINISTRATION AND AUTOMATIC ENROLLMENT FOR***
7 ***LIFELINE AND LINK-UP?***

8 **Q. WOULD THE REVISIONS YOU HAVE PROPOSED REQUIRE ANY CHANGE**
9 **IN THE EXISTING HIGH COST LOOP SUPPORT AND LINE EXTENSIONS**
10 **PROCESSES?**

11 **A.** No. The proposed revisions should be limited to revenue replacement functions such that
12 carriers are neither net gainers nor net losers from the proposed restructure. The result
13 should be revenue neutral as discussed above. Carriers receiving High Cost support under
14 the current system should continue to receive such support, and other carriers that do not
15 currently receive High Cost support would not begin to do so – in order to achieve a
16 revenue neutral reform as proposed above.⁷⁶

17 ***ISSUE 11 - WHAT SHOULD BE THE BASIS OF AUSF CONTRIBUTIONS AND***
18 ***WHAT SHOULD BE THE STRUCTURE OF ANY AUSF SURCHARGE(S)?***

19 **Q. WHAT SHOULD BE THE SOURCE OF FUNDS FOR THE AUSF?**

20 **A.** Contributions to the AUSF, to satisfy the existing support needs and the access revenue
21 replacement function proposed here, should come from *all* telecommunications
22 providers, on an equitable, non-discriminatory and competitively neutral basis. One of
23 the central problems of the present system is that carriers who pay high intrastate access
24 charges – largely wireline IXC's and ultimately their customers -- not only have
25 obligations to contribute to explicit subsidies provided by the Arizona Universal Service

⁷⁶ The access replacement support is incremental to the high-cost support, so all that needs to be done is to add provisions to enable the access replacement mechanism. Likewise, it is incremental to Lifeline and Link-up, and not meant to disturb availability of, eligibility for, and the retail rates charged for Lifeline and Link-up.

1 Fund, but also have to bear the burden of the implicit subsidies in access charges that are
2 not borne by their competitors to the same extent (if at all). As I have explained, that
3 system imposes a competitive disadvantage upon the IXC's, who are saddled with high
4 access charges. To the extent the old implicit subsidies are now replaced with explicit
5 support, all providers of intrastate telecommunications should be required to contribute
6 on an equitable and nondiscriminatory basis to support universal service goal throughout
7 Arizona.⁷⁷

8 **Q. ARE THE EXISTING AUSF CONTRIBUTION REQUIREMENTS EQUITABLE**
9 **AND NONDISCRIMINATORY?**

10
11 A. I respectfully do not believe so. Currently, the AUSF rules specify that one-half of
12 AUSF funding is to be borne by "Category 1" providers (largely local exchange carriers
13 and wireless carriers), on the basis of access lines and interconnecting trunks,
14 respectively, and one-half of AUSF funding is to be borne by "Category 2" service
15 providers, i.e., providers of intrastate toll service (or other service providers as permitted
16 under R14-2-1204(B)(3)), on the basis of intrastate toll revenues. Not only does a
17 different contribution methodology apply depending on the type of service provider and
18 service, but perhaps more importantly, the 50-50 allocation of AUSF funding
19 responsibility may well no longer accurately reflect the providers' relative level of
20 activities in Arizona in a manner that is equitable and nondiscriminatory.

21 **Q. HOW SHOULD THE CURRENT CONTRIBUTION SYSTEM BE**
22 **RESTRUCTURED?**

23
24 A. As a general matter, at this time, AT&T believes that the contribution methodology
25 employed for the AUSF (and all state USFs) should mirror the approach currently

⁷⁷ 47 U.S.C. § 254(f) authorizes states to require that "[e]very telecommunications carrier that provides intrastate telecommunications services shall contribute, on an equitable and nondiscriminatory basis, in a manner determined by the State to the preservation and advancement of universal service in that State" (emphasis added).

1 implemented for the federal USF. Consistency between federal and state funds facilitates
2 carrier administration of their contribution and remittance obligations. Since federal USF
3 contributions method is currently based upon a percentage of interstate/international retail
4 (end user) telecommunications revenues, the AUSF contribution should be based upon a
5 percentage of the total retail intrastate telecommunications revenues in Arizona.⁷⁸
6 Moreover, all contributing carriers should be allowed the option to recover their
7 contributions from their end users. As I illustrate below, based on current data, that will
8 be less than 1 percent of a carrier's end user charges.

9 **Q. PLEASE ILLUSTRATE HOW THE CONTRIBUTION ASSESSMENT WILL BE**
10 **CALCULATED.**

11 A. The Commission must first determine the assessment factor which can be calculated as
12 follows:

- 13 • Assessment Factor (percent) = Total 12 month AUSF Fund Requirement ÷ Total
14 (most recent calendar year) Arizona retail intrastate telecommunications service
15 revenues.

16 This percentage will be assessed equally on all providers of telecommunications service
17 in Arizona. Each provider's dollar assessment will be calculated as follows:

- 18 • Provider's Assessment = Assessment Factor (percent) x Provider's (most recent
19 calendar year) retail intrastate telecommunications service revenues.

20 Table 2 below shows that, based on the range of assumed benchmark levels (i.e. \$16.00
21 to \$20.00), the percent contribution assessment is less than 1 percent of total

⁷⁸ However, I note that changes to the federal USF contribution methodology have been under consideration for some time. At the federal level, AT&T has supported a move to a telephone numbers or numbers- and dedicated connections-based contribution methodology. If the federal contribution methodology is adopted in the future, the AUSF contribution approach should change as well, subject to a reasonable transition period, to maximize national uniformity between the state and federal systems which simplifies contribution administration for providers required to contribute to the state and federal funds.

telecommunications revenues received by Arizona telecommunications providers (i.e. ILECs, CLECs, Wireless, and IXC).

Table 2

SELECTING A HIGHER BENCHMARK WILL REDUCE THE THE AUSF CONTRIBUTION ASSESSMENT, AND KEEP RATES AT A REASONABLE LEVEL						
Recovery based on:		Tot Telecom Retail Rev				
ILEC		\$690,000,000	25.38%			
CLEC		\$314,000,000	11.55%			
Toll		\$115,000,000	4.23%			
Wireless		\$1,600,000,000	58.85%			
Total		\$2,719,000,000	100.00%			
USF Fund Requirement		No Benchmark	\$16Benchmark	\$17Benchmark	\$18Benchmark	\$19Benchmark
Current USF Fund		\$750,000	\$750,000	\$750,000	\$750,000	\$750,000
Access Replacement Distribution		\$44,099,422	\$23,117,005	\$21,767,190	\$20,758,365	\$19,335,368
USF Recovery - % Revenue Approach						
% Contribution Assessment		1.65%	0.88%	0.83%	0.79%	0.74%
Note:						
Based on						
1) AT&T analysis of the amount of access reduction at interstate parity						
2) ILECs' current retail rates provided in discovery						
3) Number of Lines from data submitted by ILECs to NECA						
4) Intrastate Revenue from FCC Monitoring Report, released December 2008, Table 1.15 Intrastate Telecommunications Revenues: 2006 End-User						

ISSUE 12 – ANY OTHER SPECIFIC REVISIONS TO THE AUSF.

Q. DOES AT&T PROPOSE ANY CHANGES TO THE AUSF OTHER THAN THOSE DESCRIBED ABOVE?

A. No

Q. DOES THIS CONCLUDE YOUR DIRECT TESTIMONY?

A. Yes.

OA0_Exhibit A

List of Testimonies by Dr. Ola Oyefusi

State	Docket No.	Subject	Date
New Jersey	Docket No. TX08090830	In the Matter of the Board's Investigation and Review of Local Exchange Carrier Intrastate Access Rates	February 13, 2009 (Initial Testimony), April 20, 2009 (Reply), June 22, 2009 (Rebuttal)
Pennsylvania	Docket No. I-00040105	Investigation Regarding Intrastate Access Charges and IntraLATA Toll Rates of Rural Carriers and the Pennsylvania Universal Service Fund	December 10, 2008 (Direct), January 15, 2009 (Rebuttal), & February 10, 2009 (Surrebuttal)
Massachusetts	07-9	Petition for Investigation under Chapter 159, Section 14 of the Intrastate Switched Access Rates of Competitive Local Exchange Carriers	August 20, 2008 (Pre-filed)
Virginia	Case No. PUC-2007-00108	Petition of Sprint Nextel for reductions in the intrastate carrier access rates of Central Telephone Company of Virginia and United Telephone-Southeast, Inc.	August 1, 2008
New Hampshire	DT 06-067	Bayring Petition into investigation of Verizon New Hampshire's practice of imposing access charges, including carrier common line, on calls which originate from Bayring's network and terminate on wireless carriers' networks.	March 9, 2007 & April 20, 2007
New Jersey	TT 04060442	Application of Verizon New Jersey, Inc. for a Revision of Tariff B.P.U.- N.J. No. 2, providing for a Revenue Neutral Rate Restructure Including a Restructure of Residence and Business Basic Exchange Service and Elimination of \$.65 Monthly Credit	January 18, 2005 (Rebuttal)
New Jersey	TO 01020095	Application of Verizon New Jersey for approval (i) of a new alternative regulation plan, (ii) to reclassify multi-line regulated business as competitive services.	January 9, 2005 (Direct) & February 4, 2005 (Rebuttal)
Pennsylvania	C-20027195	Remand of Verizon access reduction proceeding	June 29, 2005
Pennsylvania	R-00049812	Verizon Pennsylvania Inc.'s Petition for Expedited Adoption of an Interim Rate Pending Determination of Final Rates for Time and Material	November 15, 2004 (Direct) & December 7, 2004 (Rebuttal)
Pennsylvania	C-20027195	Investigation into VZ access rates	July 18, 2003

Virginia	PUC-2002-00088	Petition of Cavalier Telephone LLC for injunction against Verizon Virginia Inc. for Violations of interconnection agreement and for expedited relief to order Verizon to provision Unbundled Network Elements in accordance with the Telecommunications Act of 1996	June 2, 2003
Delaware	96-324, Phase II	In the matter of the application of Verizon Delaware Inc. for approval of its Statement of Terms and Conditions under section 252(f) of the Telecommunications Act of 1996 and code of conduct	September 14, 2001
District of Columbia	Formal Case No. 962	In the Matter of the Implementation of the District of Columbia Telecommunications Act of 1996 and Implementation of the Telecommunications Act of 1996	October 9, 2001
DC	Formal Case No. 814, Phase IV	Rate design for telecommunications services, development of productivity measurements under a price cap plan, use of incremental cost as a price floor for competitive telecommunications services, criteria for determining competitive telecommunications services, critique of the alternative incentive regulation adopted in Phase III, and classification of telecommunications services	July 1, 1995
DC	Formal Case No. 920	Telecommunications needs of residents, business community and government entities in the District of Columbia, introduction of new telecommunications services in the District of Columbia, and mechanisms for reviewing and monitoring Bell Atlantic's construction plans and budget	March 18, 1994
DC	Formal Case No. 926	Rate design and determination of total factor productivity	July 30, 1993
DC	Formal Case No. 814, Phase III	Market structure, determination of market share, pricing flexibility, and significance of economies of scale and economies of scope	October 13, 1992
DC	Formal Case No. 912	Rate structure, pricing information and energy conservation	April 3, 1992

OAO_Exhibit B

Arizona Access Rates - Carrier Common Line			
	Range		
	Originating		Terminating
Table Top Telephone Company	3.60¢	To	4.00¢
Southwestern Tel	1.00¢	To	22.93¢
Copper Valley Telephone, Inc	2.00¢	To	2.00¢
Arizona Telephone Company	1.00¢	To	3.02¢
Valley Tel Coop Inc	5.89¢	To	5.89¢
Midvale Telephone Exchange	2.00¢	To	5.44¢
South Central Utah Telephone Association	3.62¢	To	5.12¢
Accipter (Zona Communications)	1.00¢	To	2.42¢
Citizens Frontier-Rural	1.94¢	To	4.82¢
Citizens Frontier-White Mountain	2.42¢	To	10.46¢
Citizens Frontier-Navajo	1.00¢	To	2.27¢
Verizon	2.43¢	To	7.18¢
Qwest	None		

Notes:

Sources - Publicly available access tariffs

Rates per minute of use as defined in the carrier's access tariff

OA0_EXHIBIT C Page 1 of 2

Verizon's Excessive Access Rates Exceed AT&T Long Distance Prices, Substantially Inhibit Competition, and Prevent Lower Prices for Arizona Consumers



OAO_EXHIBIT C Page 2 of 2

Citizen's Average Access Rates Exceed AT&T Long Distance Prices, Substantially Inhibe Competition, and Prevent Lower Prices for Arizona Consumers



OAO_Exhibit D

BEGIN HIGHLY CONFIDENTIAL

	How much more IXCs pay to the Arizona carriers by paying Intrastate vs Interstate Access Rates			
Carrier	Annually	Per Day	Per Month	%

Notes:

Sources - AT&T analysis of data from Responses to Staff Discovery Request, AT&T Discovery Request.

END HIGHLY CONFIDENTIAL



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October 27, 2009

The Honorable Henry A. Waxman
Chairman
Committee on Energy and Commerce
U.S. House of Representatives
2125 Rayburn House Office Building
Washington, DC 20515-6115

The Honorable Rick Boucher
Chairman
Subcommittee on Communications, Technology and the Internet
Committee on Energy and Commerce
U.S. House of Representatives
2187 Rayburn House Office Building
Washington, DC 20515

The Honorable Bart Stupak
Chairman
Committee on Oversight and Investigations
U.S. House of Representatives
2268 Rayburn House Office Building
Washington, DC 20515

Dear Chairmen Waxman, Boucher, and Stupak:

I am responding to your letter to our Chairman and CEO, Randall Stephenson, dated October 14, 2009. AT&T is pleased to assist the Committee in its review of traffic pumping abuses of the access charge regime that governs compensation for the termination of long distance calls to the local premises of actual end users.

Traffic pumping schemes involve unscrupulous incumbent local exchange carriers ("ILECs"), as well as "competitive" local exchange carriers ("CLECs"), many established for the sole purpose of engaging in scams, that: (i) establish grossly excessive access charges under false pretenses; (ii) offer kickbacks to operators of calling services that agree to advertise their services (typically for "free") to anyone who dials telephone numbers assigned by the LECs; and (iii) bill AT&T and other interexchange carriers ("IXCs") "terminating" access charges for millions of calls and billions of minutes of communications between non-residents of the small communities the LECs purport to serve. AT&T and others are engaged in litigation with many current perpetrators for their violations of existing law, but given the ease with which these schemes are implemented and shifted rapidly to other locations, it is clear that after-the-fact, case-by-case litigation could never fully protect the public interest. Accordingly, AT&T and others have also sought action from the FCC and state commissions to put an end to these

practices. Legitimate competitive LECs and conference service providers have likewise urged the FCC to put an end to traffic pumping abuses.¹

The enormous public harms from these schemes are well-documented and indisputable. By significantly inflating long distance carriers' costs, traffic pumping forces ordinary long-distance customers throughout the nation to fund the schemers' windfall profits. The lure of those windfall profits has diverted the resources and focus of real LECs away from their proper role of providing high quality local services to actual residents. These schemes have depleted already strained universal service fund resources, as traffic pumping LECs ("TP LECs") seek and obtain millions of dollars in high-cost Universal Service Fund ("USF") support on the basis of "access lines" they claim to provide to their free calling service partners. Traffic pumping can degrade service to ordinary customers by clogging up transport and switching facilities. And, because these schemes use ordinary telephone numbers, they provide ungated access to "free" pornographic content, thus circumventing the laws designed to ensure that parents can prevent their children from accessing such content.²

One need only consider the case of Aventure Communications Technology, LLC to understand the nature and scope of the traffic pumping problem. To obtain its Certificate of Public Convenience and Necessity and its eligibility for universal service support, Aventure represented to the Iowa Utilities Board ("IUB") that it intended to provide local exchange service in numerous rural exchanges in Iowa and aggressively to market those services to the Iowa residents of those communities. Instead, Aventure set up chat and other traffic pumping schemes – which it did exclusively for more than two years, without constructing a local exchange network and without serving a single real Iowa resident Iowa residential service customer. To inflate its access revenues even further, Aventure concocted a truly absurd call routing scheme that had it billing for more than 200 miles of "local" transport through three states. Aventure has received further windfalls in the form of millions of dollars in USF high-cost support by representing that it would use moneys it received to provide USF-supported services and by misrepresenting the number of lines it served.

Traffic pumping schemes are unlawful in many respects, as the Iowa Utilities Board ("IUB") recently concluded after an exhaustive review of an extensive factual record developed in a two year proceeding involving eight incumbent and competitive LECs operating in rural

¹ See, e.g., Ex parte letter from Counsel to the Rural Independent Competitive Alliance to FCC filed October 23, 2008 in FCC Docket No. 07-135 ("RICA agrees that the access stimulation issues may be addressed by establishing a requirement for CLECs to revise and reduce their tariff access rates in the event that traffic exceeds specified thresholds"); Ex Parte letter from David Frankel, CEO of ZipDX LLC to FCC, filed August 28, 2009 in FCC Docket No. 07-135 ("the abuse of rural access charges has been allowed to linger for far too long. . . . This undermines fragile funding mechanisms and will impede broadband enhancements. Rule clarifications proposed by ZipDX are non-controversial for any legitimate player not attempting to game the system").

² See 47 U.S.C. § 228.

areas of Iowa that have been a hotbed of traffic pumping activity. The IUB found that these TP LECs violated their own tariffs, violated the law and, in a failed effort to hide their unlawful behavior, even fabricated and backdated documents in an attempt to transform their free calling partners into "end user customers" and their own switching facilities where the chat and conferencing equipment was located into "end user premises."

As described in more detail below, the IUB proceeding, which addresses Iowa *intrastate* access charges, is one of many ongoing proceedings currently pending before federal courts and the FCC in which the lawfulness of the LECs' access charge billings in connection with traffic pumping schemes is being litigated. To be clear, AT&T is complying with the FCC's June 2007 declaratory ruling that prohibits call blocking.³ Rather, AT&T continues to deliver calls associated with the traffic pumping schemes, and, in accordance with the TP LECs' own tariffs and established law, has followed accepted industry practices by disputing the charges and withholding payment pending resolution of those disputes.

Against this backdrop, we respond below to your specific questions.

1. **Is your company currently engaged in any disputes with rural ILECs or other rural carriers over the payment of terminating access charges?**
 - a. **If so, please describe the nature and basis of such disputes and provide the Committee with the names of those companies and the total disputed dollar amount at issue in each dispute with each company.**
 - b. **Please describe all steps your company has taken in these disputes. For example, is your company currently involved in litigation or regulatory proceedings related to the disputes?**

AT&T is currently involved in a number of access charge disputes with traffic pumping LECs. In 2006 the traffic volumes and corresponding billings of certain LECs located in very rural areas inexplicably began to skyrocket. These rural areas are sparsely populated (often only a few hundred people) and have typical call volumes of only a few thousand minutes per month. Yet, suddenly, and with no explanation, some LECs began billing AT&T for millions – even tens of millions – of minutes per month for calls to these rural areas. Even if every resident of these areas spent every waking minute of every day on long-distance calls, the resulting call volumes still would not even begin to approach the billed call volumes. As just one example, a "competitive" LEC that was supposedly serving customers in very sparsely populated areas on the border of Utah and Nevada suddenly began in April 2006 to bill AT&T terminating access for more than *ten million* minutes of calls in a single month.

³ See Declaratory Ruling and Order, Establishing Just and Reasonable Rates for Local Exchange Carriers, 22 FCC 2d. 11629, ¶ 5 (2007) ("carriers cannot engage in self help by blocking traffic to LECs allegedly engaged in the [traffic pumping] conduct described herein").

AT&T began investigating these unusual calling volumes and discovered that virtually all of these calls were placed to only a few telephone numbers. AT&T personnel called these numbers and determined that they were associated with so-called "free" chat and conference services, international calling, and other services. Several of the "chat lines" offered obscene and pornographic content and allowed as many as 270 out-of-state callers simultaneously to conduct conversations by calling a single telephone number, typically with the capability for callers to access a "back room" to conduct one-on-one conversations. Other telephone numbers provided "free" international calling by allowing callers to dial an Iowa (or Minnesota, Utah or South Dakota) telephone number and then enter an international telephone number to which the TP LEC would then route the call. At least one TP LEC appeared to be using autodialing equipment to place tens of thousands of calls to both wireless and wireline customers in an attempt to entice them (e.g., by offering commercial credit cards, often *without* the knowledge of the credit card company) to call a telephone number in the TP LEC's local exchange, and when such customers placed those calls, the TP LEC billed terminating access service fees to the long distance carrier that delivered the call. None of the high volume telephone numbers AT&T investigated appeared to be associated with any actual residential or business customers of these LECs. And for each minute associated with these schemes, the TP LECs were billing extremely high access charges, typically 3 to 10 cents/minute (and in one case more than 23 cents/minute).

Upon discovering that these TP LECs were engaged in these traffic pumping schemes, AT&T informed them that it was disputing their charges, and, in early 2007, AT&T initiated litigation in Iowa against many of the TP LECs and calling service providers engaged in these schemes. This was the first of many lawsuits, some initiated by AT&T and/or other interexchange carriers and some initiated by TP LECs. Some of these disputes have since been settled under confidential terms, but others continue to be actively litigated.

In July 2007, the FCC suspended the tariff filings of a number of incumbent LECs suspected of engaging in (or preparing to engage in) traffic pumping, ordering them either to prove that their charges were lawful by providing cost justification or to return to the National Exchange Carriers Association ("NECA") tariff "pool," where they could no longer profitably engage in such schemes (because any earnings would then be shared with the hundreds of other LECs that participate in the NECA pool, making it impossible for the TP LEC to pay the necessary kickbacks to its free calling partners).⁴ Although traffic pumping activity by incumbent LECs has fallen off dramatically in the wake of this FCC decision, supposed "competitive" LECs, which operate under different rules, have more than made up the difference – indeed, there are now individual "rural" CLECs that are generating more than 100 million minutes of traffic pumping calls *each month*.

⁴ See Order Designating Issues for Investigation, *Investigation of Certain 2007 Annual Access Tariffs*, 22 FCC Rcd. 16109 (2007). The FCC also provided the LECs with a third option under which they were required to add terms to their tariffs that they would immediately and significantly reduce their access rates if their traffic volumes increased significantly, thus significantly reducing incentives to engage in traffic pumping. *Id.*

Federal Court Litigation. Today AT&T is involved in the following federal court lawsuits against traffic pumping LECs: (i) in the Southern District of New York, AT&T is involved in litigation with All American Telephone Company, Chase.Com and E-Pinnacle (all Utah/Nevada CLECs); discovery is ongoing in this dispute that involves approximately \$15 million in access billings to AT&T; (ii) in the Southern District of Iowa, AT&T is involved in litigation with Aventure Communications Technology, LLC (an Iowa CLEC); this case, which involves approximately \$15 million in access billings to AT&T, is currently stayed pending action by the FCC; and (iii) in South Dakota District Court, AT&T is involved in litigation with Sancom Inc. and Northern Valley Communications, LLC (both South Dakota CLECs); discovery is ongoing in this dispute that involves approximately \$25 million in access billings to AT&T.

State Public Utility Commission Proceedings. AT&T is also a party to ongoing proceedings related to the Iowa Utilities Board's September 21, 2009 Order.⁵ In that order, the IUB – after more than two years of proceedings that included depositions and document discovery from traffic pumping LECs, thousands of pages of briefing and expert testimony, and live hearings – found that the traffic pumping LECs had “manufacture[d] evidence, after the fact” and “concealed truths from the Board and the FCC” to make it appear that their free calling service partners’ (“FCSPs”) bridging and other equipment were “end users” and that the LEC central offices where that equipment was located were “end user premises” that justified the billing of terminating access charges for calls to such equipment. *Id.* at 30, 34. The IUB found that, in truth, “none of the FCSCs associated with the [LECs] were end users for purposes of the [LECs’] intrastate exchange access tariffs, none of the intrastate toll traffic associated with the FCSCs terminated at the end user’s premises, and much of the intrastate toll traffic associated with the FCSCs did not terminate in the Respondents’ certificated local exchange area.” *Id.* at 53-54. The IUB thus concluded that “intrastate access charges did not apply to calls to the FCSCs and should not have been billed to the IXC for calls to numbers assigned to the FCSCs.” *Id.*⁶

AT&T is a participant in additional proceedings before the IUB that have been initiated in response to this IUB Order. First, the traffic pumping LECs have filed petitions for reconsideration of the order, and AT&T is opposing those petitions. Second, pursuant to the IUB

⁵ See, e.g., *Qwest v. Superior Tel. Coop.*, Final Order, Docket No. FCU 07-2, at 61-62 (Iowa Utilities Board, Sep. 21, 2009) (“IUB Order”).

⁶ The IUB was especially troubled by the fact that the LECs had “partnered with FCSCs that provided free calling services for indecent or pornographic content” and that “there were no technological measures in place to protect minors from making calls to access these pornographic services, such as a 1-900 number, which enables parents to place a block on the call.” IUB Order At 61-62. The Board found this “lack of any mechanism for parents to regulate their minor children’s access to pornographic or indecent services over the telephone is contrary to the public interest.” *Id.* In addition, the IUB further found that these traffic pumping schemes led to “other schemes, such as the improper backdating of invoices and contracts, traffic laundering, telephone numbering abuses, and potentially misrepresented universal service fund (USF) certifications.” *Id.* at 8.

Order, there are ongoing proceedings to determine the amount of refunds that the Iowa traffic pumping LECs owe to AT&T and other long-distance carriers. Third, the IUB has opened a rulemaking proceeding to adopt rules designed prospectively to discourage traffic pumping.

AT&T is also a participant in proceedings that the Public Service Commission of Utah has initiated to assess whether All American's state authorization should be rescinded. The certificate that Utah granted to All American in 2006 was expressly conditioned on All American's representation that it would not provide service in rural portions of the state. In fact, All American has operated *solely* in the areas it said it would not serve, has no real customers, and has done nothing but engage in traffic pumping.

FCC Proceedings. AT&T is also a party to three ongoing FCC proceedings involving traffic pumping. First, AT&T is opposing frivolous petitions filed by Iowa TP LECs seeking to have the FCC preempt the IUB Order. The IUB Order addressed *intrastate* terminating access charges that Congress placed squarely within the jurisdiction of the IUB.

Second, AT&T is participating in a rulemaking proceeding initiated by the FCC in 2007 in response to allegations of traffic pumping to assess the need for rule changes to ensure that "rules governing the tariffing of traffic-sensitive switched access services by local exchange carriers (LECs) are ensuring that rates remain just and reasonable, as required by section 201(b) of the Communications Act of 1934, as amended (the Act)."⁷

Third, pursuant to a referral order by the United States District Court for the Southern District of New York, AT&T has filed a complaint with the FCC against All-American, Chase.Com, and e-Pinnacle for engaging in a scheme to create sham entities solely for the purpose inflating access charges. Under this scheme, an ILEC called Beehive Telephone Company and its traffic pumping partner Joy Enterprises – an adult chat line operator – devised a plan to avoid the FCC rules that would have required Beehive to reduce its access rates to reflect the enormous amount of Joy-related traffic volumes it was generating. The plan was to create "competitive" LECs to bill the access charges for the traffic pumping minutes, so that those additional volumes would not be attributed to Beehive. To accomplish the shift, Beehive and Joy made a few paper changes, such as reassignment of Beehive's telephone numbers and facilities to All American, Chase.Com and e-Pinnacle, so that these CLECs would then bill AT&T for the traffic associated with the Beehive/Joy traffic pumping schemes. As AT&T's complaint explains, it has long been settled that creating "a company that purport[s] to be a bona fide carrier but which instead [is] simply a sham creation, designed to facilitate an arrangement among several entities to capture access revenues that could not otherwise be obtained by lawful tariffs" is an unjust and unreasonable practice that violates the Communications Act.⁸

⁷ Notice of Proposed Rulemaking, *Establishing Just and Reasonable Rates for Local Exchange Carriers*, 22 FCC Rcd 17989, ¶ 1 (2007).

⁸ *AT&T and Sprint Petitions for Declaratory Ruling on CLEC Access Charge Issues*, 16 FCC Rcd. 19158, ¶ 22, n.33 (2001) ("CLEC Access Declaratory Ruling"); see *Establishing Just and Reasonable Rates for Local Exchange Carriers*, 22 FCC Rcd. 11629, ¶ 6 n.20 (the

2. Has your company withheld payment of access charges relating to disagreements about the appropriate rate?

a. If so, when did your company begin withholding payments and how much was withheld or is being withheld from whom?

As permitted by established FCC precedent and the TP LECs' tariffs, AT&T has disputed and withheld payment of certain access charge billings associated with traffic pumping.⁹ AT&T is currently withholding payment of terminating access charges from the following TP LECs: All American Telephone Company (as of April, 2006), Adventure Communications Technology (as of October, 2006), Chase.Com (as of April, 2006), E-Pinnacle (as of April, 2006), North County (as of September, 2008), Northern Valley Communications (as of January, 2008), Sancom (as of January, 2008), Spencer Municipal Communications Utility (as of January, 2008), and Capital Telephone Company (as of July 2007). The total amount of disputed charges that AT&T has withheld pending resolution of the disputes is approximately \$60 million as of September 30, 2009.

3. What do you estimate the actual cost of terminating traffic to be on a per minute basis?

Although traffic pumping LECs have not disclosed their costs associated with their traffic pumping schemes, the public filings of NECA confirm that, to the extent they incur any costs at

Commission has "found that an arrangement between a chat line service provider and competitive access provider (formed by an ILEC for purposes of the arrangement) that did not provide local exchange service and had no customers other than the chat line was a sham"); *AT&T Corp. v. FCC*, 317 F.3d 227, 233 (D.C.Cir. 2008) ("the entire arrangement was devised solely in order to circumvent regulation . . . [and] deserves to be treated as a sham").

⁹ It is well established that the "responsibility for correct billings remains with the carriers" providing the service, e.g., *Tele-Valuation, Inc. v. AT&T Corp.*, 73 F.C.C.2d 450, ¶ 8 (1979), and that access customers are not obligated to pay for tariffed services that were not actually provided. See, e.g., *Iowa Network Servs., Inc. v. Qwest*, 385 F.Supp. 2d 850, 903-04 (S.D. Iowa 2005), *aff'd* 466 F.3d 1090 (8th Cir. 2006) (carrier under no obligation to pay where services were not provided under a "valid and applicable tariff"). Certain TP LECs have claimed that prior FCC decisions have held that it is illegal "self-help" to withhold payment for tariffed services, but those decisions arose in circumstances where, unlike here, it was undisputed that the tariffed services were actually provided and properly billed pursuant to an applicable tariff. See, e.g., *Business WATS, Inc. v. AT&T*, 7 FCC Rcd. 7942, ¶ 2 (1992). Indeed, the TP LECs' tariffs expressly contemplate that an access customer may withhold payment of terminating access charges pending the resolution of a dispute over whether service has been provided and charges have been properly assessed, see, e.g., Northern Valley Commc'ns L.L.C., F.C.C. Tariff No. 2, § 2.4.1(D)(4) (effective Nov. 16, 2004), and the language in these tariffs is indistinguishable from the language in other tariffs that the FCC has authoritatively interpreted, concluding that "a customer may withhold payment of disputed charges pending resolution of the dispute." See *AT&T v. Beehive*, 17 FCC Rcd. 11641, ¶ 26 & n.91 (2002).

all, the per minute costs incurred by traffic pumping LECs (even accounting for a reasonable return) to deliver traffic to the bridging equipment of their free calling partners is exceedingly small (and certainly much less than one tenth of a penny per minute).

NECA represents rural ILECs subject to FCC cost of service regulation. Pursuant to the FCC's rules, NECA makes annual filings with the FCC that report the costs of its member ILECs. The highest cost annual report submitted by NECA ("Band 8") reports the costs and computes rates for the smallest rural ILECs. As of June 2009, there were 490 rural ILECs represented in the Band 8.¹⁰ These ILECs have an average of 1,500 lines¹¹ serving widely dispersed residential and business customers that generate an average of less than 500 minutes of exchange access traffic per month per line.¹²

Based on this network cost structure – one designed to serve widely dispersed residential and business customers that make relatively few calls – NECA has developed a per minute access rate that allows Band 8 ILECs to recover these costs plus an 11.25 percent return. To compute these rates, NECA estimates the average cost of the switches, lines, and other infrastructure used by such LECs to serve their residential and business customers and spreads those costs over the total number of annual access minutes that Band 8 ILECs are expected to serve, which for 2009 is 3.5 million minutes.¹³ Based on these calculations, NECA reported to the FCC in 2009 that Band 8 LECs must charge about 3.3 cents per minute to recover their

¹⁰ See National Exchange Carrier Association, Inc., Access Service Tariff F.C.C. No. 5, Transmittal NO. 1245, (filed with the FCC, June 15, 2009).

¹¹ The most recent publicly available report showing the number of lines for NECA band 8 ILECs is for 2007 from a report filed on Sep. 30, 2008 (see NECA's Overview of Universal Service Fund, USF08AF.ZIP, available at <http://www.fcc.gov/wcb/iatd/neca.html>). The 2009 report has not yet been submitted to the FCC. However, the line counts are not likely to change significantly because the number of lines served by band 8 ILECs has historically varied very little.

¹² To compute the average monthly minutes per line for Band 8 LECs, AT&T divided the total number of minutes generated by Band 8 ILECs in 2008 as reported by NECA (see Network Usage by Carrier, Annual submission by NECA of Access Minutes of Use, NETWU08.ZIP, available at <http://www.fcc.gov/wcb/iatd/neca.html>) by 12 (to obtain average monthly minutes) and then AT&T divided that amount by the number of lines for Band 8 LECs.

¹³ To compute the average minutes per year for Band 8 LECs, AT&T divided the total number of minutes generated by Band 8 ILECs in 2008 as reported by NECA (see Network Usage by Carrier, Annual submission by NECA of Access Minutes of Use, NETWU08.ZIP, available at <http://www.fcc.gov/wcb/iatd/neca.html>) by the total number of NECA members reported by NECA as of June 2009 (see National Exchange Carrier Association, Inc., Access Service Tariff F.C.C. No. 5, Transmittal NO. 1245 (filed with the FCC, June 15, 2009)).

facilities costs and earn an 11.25 percent return.¹⁴ This is the rate “mirrored” by many so-called rural CLECs that are engaged in traffic pumping.

Given these calculations, it is clear that, even if traffic pumping LECs had the same cost structure as the Band 8 NECA ILECs (in fact, as shown below traffic pumping LECs’ incur much, much lower costs to the extent they incur any real costs at all), the per minute rates that traffic pumping LECs need to recover those costs would be a tiny fraction of the NECA rate. Whereas Band 8 LECs must spread their costs over an average of only about 3.5 million minutes per year, the pornographic chat and other services offered by traffic pumpers routinely generate that much traffic each *month* (and often much more). A traffic pumping LEC with typical NECA band 8 cost structure that generates monthly volume of 3.5 million minutes could recover its costs and a reasonable return by charging less than one third of a cent per minute.¹⁵

But even that greatly overstates the rate needed by TP LECs to recover their costs and earn a return, because the cost structure for TP LECs is not remotely similar to that of Band 8 ILECs. Whereas Band 8 ILECs have built out actual network infrastructure with lengthy wire “loops” buried or strung on poles to serve hundreds of widely dispersed residences and businesses located in their services areas, many TP LECs have built virtually nothing to serve their free calling partners. Rather, such LECs typically co-locate bridging and other equipment in the central office near the switch, so that connecting their partners’ equipment requires only few feet of cables. Some traffic pumpers even avoid the cost of the switch by collocating their traffic pumping equipment in a central office of another LEC and by relying on that other LEC’s switch to direct their traffic pumping calls to their equipment. Consequently, the costs that traffic pumping LECs must recover through their per minute rates are only a tiny fraction of the costs that must be recovered by Band 8 ILECs, which means that the actual per minute rates that traffic pumping LECs need to recover their costs are extremely small, and certainly well below a tenth of a penny per minute.

4. **Do you charge other carriers to terminate traffic on your network? If so, how much do you charge for terminating access on a per minute basis? If you charge different rates in different areas, please provide a range of charges.**

AT&T provides and charges others for both interstate and intrastate terminating access services, as follows:

¹⁴ See National Exchange Carrier Association, Inc., Access Service Tariff F.C.C. No. 5, Transmittal NO. 1245, Vol 5, Exhibit 12, Workpaper 1 of 12 (filed with the FCC, June 15, 2009).

¹⁵ As the FCC has pointed out, the additional costs of serving more minutes are very low or zero. See, e.g., Notice of Proposed Rulemaking, *Establishing Just and Reasonable Rates for Local Exchange Carriers*, WC Docket No. 07-136, ¶ 14 (released Oct. 2, 2007) (“It is well established that there is a large fixed cost to purchasing a local switch and that the marginal or incremental cost of increasing the capacity of a local switch is low (some contend that it is zero.”).

Within AT&T's 22 state franchise service areas, AT&T operates both as an ILEC and, to a limited extent, as a CLEC. AT&T's interstate rates are governed by federal law. AT&T's ILEC per minute interstate terminating access rates, for example, are governed by the FCC's "CALLS Order."¹⁶ AT&T's intrastate access charges are subject to applicable state laws. Some states require that AT&T's intrastate terminating access rates mirror its interstate rates, and other states provide for different intrastate access rates. Overall AT&T's statewide average per minute terminating access charges within AT&T's franchise service areas fall within the range of about a tenth of a penny up to about a half a penny per minute.

Outside of AT&T's franchise territory, AT&T operates only as a CLEC. Rates vary by and within states. Overall, AT&T's statewide average per minute terminating access charges outside of AT&T's franchise area range from about four tenths of a penny to about 1.3 cents per minute.

5. How much do you receive annually in terminating access charges?

The total amount of terminating access charges that AT&T ILECs and CLECs receive can depend upon many factors. For the calendar year 2008 the AT&T ILECs and CLECs provided, in total, between \$700 million and \$800 million in per minute terminating access services to their access customers to allow them to complete calls over AT&T's local telephone networks that provide wireline connections to tens of millions of residences and businesses.

6. How much do you pay to others in terminating access charges?

The total amount of terminating access charges that AT&T pays to others can depend upon many factors. For the calendar year 2008 AT&T paid to others between \$700 million and \$800 million in per minute terminating access charges.

* * * *

We trust that the foregoing information aids in your understanding of these issues. We respectfully suggest that, to ensure that you have a comprehensive view of the ways in which the legacy access charge regime suffers from and enables fraud and abuse, you not limit your inquiry by focusing on either the providers of end-user calling services, such as Google Voice, or the LECs that engage in traffic pumping schemes. Calling services like Google Voice, MagicJack and Speakeasy are enabled by wholesale transport providers partners like Bandwidth.com and YMax. These transport providers play an increasingly central role in the transiting of traffic, but the manner in which they assess and pay access charges is often unclear and potentially inconsistent with existing rules and limitations; therefore, they, too, deserve your thoughtful attention. For instance, it would be helpful to understand whether, in connection with Google Voice, Bandwidth.com or any other CLEC assesses originating or terminating switched access on calls in-bound to a Google Voice number or on 8YY toll-free calls placed by a Google Voice

¹⁶ Sixth Report and Order, Access Charge Reform, *Price Cap Performance Review for Local Exchange Carriers*, 15 FCC Rcd. 12962 (2000).

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user and, if so, whether the assessment is for the entire duration of the calls, which network facilities are used in each circumstance, and what, if any, access functions are actually performed. This type of information would better inform you, the FCC and other stakeholders regarding the best way to guard against further abuses of the access charge framework. In this regard, it is important to understand the disproportional impact of traffic pumping on inter-exchange carriers such as AT&T given that providers such as Google Voice, MagicJack and Speakeasy take the position that they are not subject to the FCC order prohibiting the blocking of calls to high cost rural areas.

Please let me know if we can be of further assistance in connection with these matters.

Sincerely,

A handwritten signature in black ink, appearing to read "Jim McKone". The signature is written in a cursive, slightly stylized font.

cc: The Honorable Joe Barton, Ranking Member
The Honorable Cliff Stearns, Ranking Member
Subcommittee on Communications,
Technology, and the Internet
The Honorable Greg Walden, Ranking Member
Subcommittee on Oversight and
Investigations

STATES WITH INTRASTATE/INTERSTATE ACCESS PARITY

States that Mandate Intrastate/Interstate Parity by Statute for Certain Carriers

Six states have mandated reduction of intrastate access rates to interstate rate levels by statute, and some have also directed the state utilities commission to ensure compliance through further proceedings and tariff oversight. These states are listed below with a summary of relevant state activities.

Maine: In Maine, the legislature ordered the commission to ensure intrastate mirroring of interstate switched access rates: "By May 31, 2005, the commission shall insure that intrastate access rates are equal to interstate access established by the Federal Communications Commission as of January 1, 2003."¹ The Maine public utilities commission implemented the statutory directive by adopting a rule requiring each local exchange carrier to implement access mirroring by June 1, 2003, and to refresh the mirrored rates on June 1 every two years thereafter.²

Texas: The Texas legislature established interstate-intrastate access parity with a directive to incumbent local exchange companies to "reduce both the company's originating and terminating per minute of use switched access rates in each market to parity with the company's respective federal originating and terminating per minute of use switched access rates" on the date the last market of that incumbent carrier is deregulated.³ The statute also requires a "transitioning ILEC" – an ILEC for which at least one, but not all, of its markets has been deregulated – that has greater than 3 million access lines, to reach parity after a phased reduction.⁴ The statute further requires incumbent carriers that have established parity to maintain parity on an ongoing basis for all switched access rates.⁵ Importantly, in order to prevent abusive CLEC access rate practices, the statute further requires all CLECs to charge switched access at rates no higher than (a) the prevailing rates charged by the incumbent carrier serving that area; or (b) a statewide average ILEC composite switched access rate as calculated by the state commission.⁶

Other statutory provisions, however, shield certain ILECs from the requirement to reduce intrastate access charges to parity with interstate rates. Specifically, "transitioning" ILECs with fewer than 3 million access lines and "newly designated transitioning" ILECs are governed by

¹ Maine Revised Statutes Annotated, Title 35-A, Chapter 71, sec. 7101-B Access Rates (effective May 2, 2003).

² Code of Maine Rules, 65-407 Ch. 280, section 8B (current through Aug. 2008).

³ V.T.C.A., Utilities Code, sec. 65.201(a).

⁴ V.T.C.A., Utilities Code, sec. 65.202(a).

⁵ *Id.* at sec. 65.201(b) & 65.202(b).

⁶ *Id.* at sec. 52.155 (and allows for higher rates only upon commission approval).

other rate reduction provisions that could lead to parity with interstate rates but do not mandate parity. Transitioning carriers are subject to phased rate reductions, but are required to reach parity only when 75% of their exchanges are deregulated by the Commission.⁷ In addition, there are statutory provisions that permit certain ILECs (primarily small and rural companies) to elect incentive regulation under Chapter 59 of the Public Utility Regulation Act. ILECs electing incentive regulation under Chapter 59 are not subject to the requirement that intrastate access be reduced to parity with interstate rates.⁸

Oklahoma: Oklahoma by statute requires each local telecommunications service provider serving 15% or more of the access lines in the state to maintain intrastate switched access tariffs "in parity with the *terms and conditions* of the interstate access tariffs of that company," and to ensure on an ongoing basis to "maintain the terms and conditions of the intrastate access tariffs of that company so that they are in parity with the terms and conditions of the interstate tariffs of that company."⁹ There is no current parity requirement for Switched Access *rates* for Oklahoma. Oklahoma had previously required mirroring until certain revenue reduction targets had been met.¹⁰ Oklahoma carriers will no longer be required to flow through any access reductions effective July 1, 2009.

Michigan: The Michigan Telecommunications Act requires local carriers with more than 250,000 access lines to establish intrastate MOU access rates that do not exceed their interstate counterparts in order to be considered "just and reasonable."¹¹ Currently, AT&T Michigan and Verizon (soon to be Frontier) are the only local carriers that meet this threshold.

Indiana: By statute, Indiana provides that in any proceeding before the state commission, including any interconnection agreement or statement of generally available terms and conditions, "the commission shall consider the provider's rates and charges for intrastate access service to be just and reasonable if the intrastate rates and charges mirror the provider's interstate rates and charges."¹² The Indiana commission has approved parity arrangements over the years both for large and small incumbent local exchange companies.¹³

⁷ V.T.C.A., Utilities Code, secs. 65.203 & 65.204.

⁸ V.T.C.A., Utilities Code, secs. 59.025 (Commission cannot reduce the switched access rates of carriers electing infrastructure commitment under Chapter 59).

⁹ 17 Oklahoma Statutes sec. 17-139.103.D.4 (1997).

¹⁰ *Id.* at 3.

¹¹ Michigan Compiled Laws, chap. 484.2310, sec. 310(2) (1991).

¹² Indiana Code chap. 8-1 -2 .6. sec. 1.5 (c) (2) (2006).

¹³ *See, e.g.,* Re: Universal Service Reform. Cause No. 42144.2004 W.L. 1170315 at par.38. *See also, Re: Indiana Bell Telephone Company, Inc.,* Cause No. 42405 (2004 WL 2309824 at par.22) (continuing mirroring of Indiana Bell intrastate and interstate switched access rates).

Georgia: By statute enacted in 1995, Georgia required all Tier 1 and Tier 2 local exchange carriers to reduce their switched access rates to interstate levels. The statute mandates for Tier 1 carriers that "The rates for switched access ... shall be no higher than the rates charged for interstate access by the same local exchange company."¹⁴ Based on this requirement, AT&T (the only Tier 1 carrier in Georgia), must maintain parity between its intrastate and interstate switched access charges. The statute required Tier 2 carriers to reduce, by July 1, 2000, their intrastate rates to parity with their July 1, 1995 interstate rates.¹⁵

New Mexico: The legislature in 2005 amended the Rural Telecommunications Act of New Mexico to require intrastate switched access rates to mirror interstate rates.¹⁶ Current commission administrative rules implementing the legislation provide that effective January 1, 2008, "a local exchange carrier's intrastate switched access charges may not exceed the interstate switched access charges approved by the federal telecommunications commission as of January 1, 2006, and its intrastate switched access elements and structure shall conform to the interstate switched access elements and structure approved by [the FCC]."¹⁷ The rules also provide a mechanism to require carriers to continue to mirror updated interstate switched access rates.¹⁸

States that Mandate Intrastate/Interstate Parity by Statute, but Directly or Indirectly Tie Access Reform to a Carrier's Plan for Alternative Regulation/Price Regulation

Two states establish intrastate-interstate switched access parity by statute, but tie the reduction to parity to a participating local exchange carrier's plan for alternative regulation. This approach generally produces, at a minimum, a revenue-neutral event.

Kansas: Kansas statutes provide for reduction of switched access rates to interstate levels, with corresponding allowances for increases in retail local exchange rates: "Subject to the Commission's approval, all local exchange carriers shall reduce intrastate access charges to interstate levels as provided herein. Rates for intrastate switched access, and the imputed access portion of toll, shall be reduced over a three-year period with the objective of equalizing interstate and intrastate rates in a revenue neutral, specific and predictable manner. The Commission is authorized to rebalance local residential and business service rates to offset the intrastate access and toll charge reductions."¹⁹ While Kansas does not necessarily tie access rate reductions to a participating local exchange carrier's plan for alternative regulation, any

¹⁴ Ga. Code Ann. sec. 46-5-166(f)(1)(1995).

¹⁵ *Id.* at (f)(2).

¹⁶ NMSA Sections 63-9H-1 et seq. (2005, amending 1978 law).

¹⁷ N.M. Admin. Code 17. 11.1 0.8(C) (2005).

¹⁸ *Id.* at 17. 11. 10.8(I).

¹⁹ Kansas Code chap. 66. Sec. 66-2005(c)(1996).

reductions are subject to the Commission's approval. The Kansas Corporation Commission is expected to rule by the end of the year in a docket considering whether to reduce Embark's intrastate access rates to parity with its interstate rates.

Wisconsin: Wisconsin statutes establish a system for local exchange companies to elect price regulation, and for price-regulated local companies to reduce intrastate access rates to interstate levels.²⁰ Price-regulated local exchange carriers with more than 150,000 local lines are directed that "Intrastate access service rates ... may not exceed the utility's interstate rates for similar access services."²¹ The directive includes eliminating half of all carrier common line charges within one year, a prohibition against reinstating these charges, and elimination of all carrier common line charges within the earlier of two years or authorization to provide interLATA services.²² The statute provided a more graduated scale for access reductions for carriers with fewer than 150,000 lines.²³

Wisconsin's statutes also establish a system to allow a telecommunications utility to file for approval of an alternative regulation plan ("ARP").²⁴ The statute lists factors that the Commission must assess in considering an ARP, but there is no specific requirement regarding intrastate switched access charge reductions. Carriers typically include such reductions in their plans, but the reductions are not required to establish parity with interstate rates. Typically, these rates are set with reference to benchmarks the Commission established in a 1993 proceeding.

Only Verizon and AT&T have elected price regulation and, therefore, these are the only carriers subject to the state's mirroring requirement. All other independent companies are either regulated through the terms of their alternate regulation plan or have retained rate of return regulation.

States That Mandate Intrastate/Interstate Parity or Cost-Based Pricing by Commission Order, Rule or Tariff, Including Where Subsequently Modified

Nine state commissions have instituted mirroring or near-mirroring of interstate switched access rates for local exchange carriers, although two have subsequently modified this approach. These states generally permit carriers to implement some form of alternative price regulation to ensure revenue neutrality.

²⁰ See generally, Wis. Stat. Ann. 196.196.

²¹ *Id.* at 196.196(2)(b)1.

²² *Id.* at 196.196(2)(b)1-3.

²³ *Id.* at 196.196(2)(b)3.(c).

²⁴ Wis. Stat. Ann. 196.195(12).

Alabama: In 1995, the Alabama Public Service Commission allowed South Central Bell to elect price regulation with various conditions, including requiring South Central Bell to maintain intrastate access charges at a level not to exceed interstate access rates for a period of five years. After expiration of the five year period, South Central Bell was required to continue to cap these rates at "the lower of the intrastate rates in effect on July 1, 1999, or the effective interstate prices and structures approved by the FCC."²⁵ Subsequently, in December 2004, the Commission adopted a Price Flexibility Plan for BellSouth that capped BellSouth's combination of the traffic sensitive per minute charge for originating and terminating switched access service at the then "effective intrastate level (including any non-traffic sensitive rate elements)."²⁶

The Price Flexibility Plan for ILECs is the same as BellSouth's for intrastate switched access rates. The Price Flexibility Plan for Large CLECs and the Small CLECs/Toll Service Provider Streamlined Regulation Plan do not address switched access services.

Ohio: ILECs in Ohio have been required by the Ohio Public Utilities Commission to mirror their federal access rate structure for intrastate switched access rates, a policy in place since 1987.²⁷ In 2007, the Commission reiterated its support for earlier orders requiring the four largest incumbent local exchange carriers to mirror their then-current interstate switched access rates for intrastate access services.²⁸ At the same time, the Commission also ordered competitive local exchange carriers to mirror their respective interstate rates.²⁹ Note that the Commission has made an exception to the mirroring requirement with respect to the CCLC. The Commission capped the intrastate CCLC at 1987 levels. Nonetheless, Ameritech, CBT and Verizon have taken steps to reduce or eliminate the intrastate CCLC due to merger conditions and alternative regulation plans. ILECs other than the four largest incumbents mirror interstate rates that were in effect a decade ago.

Illinois: The Illinois Commerce Commission ("ICC") has aggressively reduced intrastate switched access rates. In 2000, the ICC ordered the larger incumbent local carriers to remove all non-cost-based rate elements from intrastate switched access rates, and also to reduce all remaining cost-based access rate elements to their underlying long run service incremental costs,

²⁵ *In Re Petition of South Central Bell Telephone Company to Restructure its Form of Regulation, etc.*, Docket Nos. 24499, 24472, 24030, 24865, Report and Order, September, Ala. P.S.C. (1995) at par. 9.03.

²⁶ *In Re Proposed Revisions to the Price Regulation and Local Competition Plan*, Docket No. 28590, Order Approving Alabama Telecommunications Regulation Plan, December, Ala. P.S.C. (2004) at Appendix A, page 9, section 7.C.

²⁷ *In Re Modification of Intrastate Access Charges*, Case No. 00-127-TP-COI, Opinion and Order, (2001 WL 283031) at par. 2, citing *In the Matter of the Commission's Investigation Relative to Establishment of Intrastate Access Charges*, Case No. 83-464-TP-COI, Subfile C (May 21, 1982 and March 12, 1987).

²⁸ *In the Matter of the Establishment of Carrier-to-Carrier Rules*, Case No. 06-1344-TP-ORD, Entry on Rehearing, Ohio P.U.C.(2007), at par. 29, p. 18.

²⁹ *Id.*

plus a reasonable allocation of shared and common costs.³⁰ Illinois intrastate switched access rates appear to be at or below interstate rates based on tariff filings.

The mid-size carriers are under rate-of-return regulation and generally try to mirror interstate rates. Proposed changes to the small independent companies' switched access rates are subject to the ICC's jurisdiction upon carrier complaint. CLECs are not subject to a mirroring requirement; their switched access rates are subject, however, to a statutory "just and reasonable" standard.

Massachusetts: The Massachusetts Department of Telecommunications and Energy established intrastate mirroring of interstate switched access rates in 2002, while also allowing for retail rate rebalancing: "Currently, intrastate switched access charges are higher than interstate switched access charges. This creates a situation where it could cost more for Massachusetts customers to make a call across the state than it does to make a call across the country. The Department concludes that this is inefficient. .. [T]herefore, intrastate switched access charges will be lowered to the more cost-based interstate levels."³¹ In noting that the access revenues should be made up by retail rate increases, the Department also stated that "experience has shown that such rate-rebalancing enhances efficiency without negatively impacting universal service."³²

In an order issued June 22, 2009, the Department of Telecommunications and Cable directed that all CLEC intrastate switched access rates be established at or below Verizon's intrastate switched access rates, which, in turn, are required to be set at the levels of Verizon's intrastate switched access rates. The Department required that CLEC rates would be capped at Verizon's rate effective one year from the date of its Order.³³

Kentucky: In 1995, the Kentucky Commission approved a price regulation plan for BellSouth that required BellSouth to implement switched access rates that mirrored analogous interstate access rate elements.³⁴ The Commission later stated that its earlier Order "clearly and

³⁰ *Illinois Commerce Commission, On Its Own Motion vs. Illinois Bell Telephone Company et al. Investigation Into Non-Cost Based Access Charge Rate Elements in the Intrastate Access Charges of Incumbent Local Exchange Carriers in Illinois, etc.*, 97-0601, 97-0602 and 97-0516 (March 29, 2000), at 46 through 50.

³¹ *Investigation by the Department of Telecommunications and Energy on its Own Motion into the Appropriate Regulatory Plan to Succeed Price Cap Regulation for Verizon New England, Inc. etc.*, 2002 Mass. PUC Lexis 10 (May 8, 2002), at 36.

³² *Id.*

³³ *Petition of Verizon New England, Inc., et al for Investigation under Chapter 159, Section 14 of the Intrastate Access Rates of Competitive Local Exchange Carriers*, D.T.C. 07-9, Final Order, released June 22, 2009.

³⁴ *Application of BellSouth Telecommunication, Inc., d/b/a South Central Bell Telephone Company to Modify Its Method of Regulation*, Case No. 94-121 (1995), Order; 1995 WL 135116 Ky. 1628 (1999), 1999 WL 135116 (Neb. P.S.C.), at 7. The Commission initially exempted the PICC and TIC for originating access and capped terminating rates at the levels of originating rates. The Commission also gave guidelines for residential and

unequivocally required mirroring of interstate access rates as the FCC changed access rates," and required mirroring rates to be effective no later than 30 days after the FCC changed interstate rates.³⁵ The Commission in later years approved further access reductions for BellSouth and Cincinnati Bell, citing public interest benefits associated with removing economically inefficient subsidies.³⁶

In July 2006, statutory revisions effectively changed this regulatory scheme. Current statutory provisions permit telephone utilities the option to elect a price regulation plan as described within the statute.³⁷ Under price regulation, an electing utility's rates for intrastate switched-access service "shall not exceed its rates for this service that were in effect on the day prior to the date the utility filed its notice of election."³⁸ Accordingly, Kentucky's switched access rates are capped and no longer need to mirror interstate rates. AT&T-KY filed notice of its price regulation plan election on July 12, 2006.

Oregon: In 2001, the Commission approved a Qwest rate rebalancing plan that provided substantial access reform. The Commission required Qwest to reduce switched access rates by decreasing the local switching rate and eliminating the carrier common line charge, a move calculated to "bring Qwest's intrastate switched access rates closer to its currently lower interstate switched access rates ... an equitable development with respect to consumers ..."³⁹

Tennessee: BellSouth Telecommunications Inc. ("BellSouth") agreed to reduce intrastate switched access charges to achieve parity between intrastate and interstate switched access rates that existed as of August 1, 1995 under agreement with certain interexchange carriers operating in Tennessee. This agreement was never filed with nor approved by the Tennessee Regulatory Authority ("TRA"). On January 31, 1997, BellSouth filed with the TRA a tariff to implement the first step of these reductions. The TRA initiated a docket to consider this tariff filing,⁴⁰ and issued an Order approving BellSouth's tariff as filed.⁴¹ The TRA also approved all subsequent tariff filings made to reduce rates under the agreement with IXCs.

business rate rebalancing initiatives. *Id.* at 5.

³⁵ *Telecomm, Inc.'s Application to Restructure Rates*, Case No. 97-074, Neb. P.S.C. (1997). *See also*, *Tariff Filing of BellSouth Telecommunications, Inc. to Mirror Interstate Rates*, Case No. 98-065 (1999).

³⁶ *See, e.g., Review of BellSouth Telecomm, Inc.'s Price Regulation Plan*, Case No. 99-434 Ky. P.S.C. (2000), at 5.

³⁷ Ky. Rev. Stat. 278.543.

³⁸ *Id.* at 278.543(4).

³⁹ *Re: Qwest Corporation. UT 125 Phase II*, Order No. 01-810, 213 P.U.R. 4th 78 (2001).

⁴⁰ *In Re: Tariff Filing by BellSouth Telecommunications, Inc. to Reduce Intrastate Access Charges*, Docket No. 9700185, Ten. R.A. (1997).

⁴¹ *Id.* The TRA's Order also required "the long distance companies certified to provide service within Tennessee to file tariffs as described in (TRA) Rule 1220-4-.55(2)(d). That rule requires the long distance companies to flow-through this access reduction to ratepayers in the form of lower long distance rates."

West Virginia: By Order of the Commission in March of 2007 approving Verizon's Market Transition Plan ("MTP"), Verizon will eliminate the carrier common line charge from its intrastate switched access rates and mirror interstate traffic-sensitive switched access rates over a phase-in period through year-end 2010. Verizon will be granted pricing flexibility for basic local exchange services commensurate with the revenue reductions attributable to switched access decreases. At the conclusion of the phase-in period, all Verizon intrastate switched access rates are expected to mirror interstate rates.⁴² A recent ALJ Recommended Decision, if adopted by the Commission, will require CLECs to mirror Verizon's intrastate rate by year-end 2010 as well.⁴³

States that by Tariff Establish Intrastate Access Rates Near Parity with Interstate Rates

LECs in two states have established by tariff intrastate switched access rates that are virtually at parity with corresponding interstate rates.

Mississippi: The BellSouth (AT&T) terminating intrastate access charges "are currently at parity with the FCC interstate rates and will be adjusted annually subject to a cap at parity."⁴⁴ The intrastate rates in total for a two-ended call are marginally higher than interstate rates (\$0.0095 intrastate vs. \$0.0088 interstate). The commission first ordered BellSouth to mirror intrastate and interstate switched access rates as part of a 1995 price regulation docket. The mirroring requirement remained in place as part of the 2002 price regulation proceeding and again following the 2006 deregulation proceeding. BellSouth (AT&T) is the only LEC currently required to mirror intrastate and interstate switched access rates.

North Carolina: The current BellSouth per-minute, two-ended intrastate access rate is almost identical to interstate rates at \$0.0092, compared with an interstate rate of \$0.0088.⁴⁵

Nevada Requires That Intrastate Switched Access Rates Be Consistent With Federal Law

The rates, terms and conditions for switched and special access services are currently regulated in Nevada and must be consistent with federal law.⁴⁶ Carriers may reduce switched access

⁴² *Petition for Approval of Joint Stipulation and Agreement for Settlement and Joint Petition for Expedited Approval of a Joint Stipulation for a Market Transition Plan for Verizon West Virginia Inc.*, Case No. 06-1935-T-PC., W.V.P.S.C. (2007).

⁴³ *Petition of Verizon West Virginia Inc. et als.*, Case No. 08-0656-T-GI (March 4, 2009).

⁴⁴ BellSouth Telecommunications, Inc. Mississippi, Access Services Tariff, effective January 1, 2008.

⁴⁵ *See generally*, BellSouth Access Services Tariff, sec. E.6, for Mississippi, North Carolina, Alabama, South Carolina and Florida.

⁴⁶ Nevada Revised Statutes 704.68873.

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charges to parity with the associated interstate switched access rates without a rate proceeding. The Public Utilities Commission of Nevada may deregulate switched access services provided by a competitive supplier (AT&T Nevada is one) upon its own motion or acting upon a carrier petition.⁴⁷

⁴⁷ Nevada Revised Statutes 704.68879.